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86 T.C. 138-243

ORIGINAL

UNITED STATES TAX COURT

COMPLETE
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WASHINGTON, D.C.

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JUDGES OF THE UNITED STATES TAX COURT

Chief Judge

SAMUEL B. STERRETT

Judges

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WILLIAM A. GOFFE
RICHARD C. WILBUR
HERBERT L. CHABOT
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JOEL GERBER
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DARRELL D. WILES
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UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

GENERAL ORDER NO. 9

Revocation of Obsolete General Orders

The purpose of this General Order is to revoke those general orders which have become obsolete. Accordingly, effective this date, the following general orders are revoked:

General Order No. 3 (54 T.C. VI) and Supplement 1 (55 T.C. IV)

This General Order adopted an interim rule for a limited period for the purpose of permitting a Commissioner, now a Special Trial Judge, to conduct trials, pretrial conferences, and hearings upon motions in small tax cases. The Supplement extended and modified the interim rule to include small tax cases docketed as "SC" cases prior to December 30, 1970. The order has long been obsolete. Procedures governing the conduct of trials, pretrial conferences, and hearings upon motions in small tax cases by Special Trial Judges are currently prescribed by Title XVIII, Tax Court Rules of Practice and Procedure, and in particular by Rules 181 and 182(a), (c) thereof, by Delegation Order No. 8, 81 T.C. XXV, and Amendment 1 thereto, 86 T.C. VIII, and by Delegation Order No. 11, 86 T.C. VII.

General Order No. 5 (67 T.C. XXI)
General Order No. 6 (69 T.C. XV)
General Order No. 8 (81 T.C. XXIII)

These three General Orders prescribed procedures for the trial or other disposition of certain regular tax cases by Special Trial Judges. These procedures have been superseded by the procedures prescribed by Title XVIII, Tax Court Rules of Practice and Procedure, and in particular by Rules 182(b), (c) and 183 thereof. See also section 7456(d), I.R.C. 1954, as amended, and Delegation Order No. 8, 81 T.C. XXV, and Amendment 1 thereto, 86 T.C. VIII, and Delegation Order No. 11, 86 T.C. VII.

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General Order No. 4 (65 T.C. IV)

This General Order provided for the use of the title of "Special Trial Judge," in lieu of "Commissioner." This order has been superseded by Rule 3(d), Tax Court Rules of Practice and Procedure, and by the amendment of section 7456(c), I.R.C. 1954, by section 464(b) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 824, which authorizes the appointment of "Special Trial Judges." The amendment of that section and related sections of the Internal Revenue Code of 1954 by the Deficit Reduction Act of 1984 evidences the statutory adoption of the title "Special Trial Judge."

General Order No. 7 (71 T.C. IV)

This General Order, which authorized Special Trial Judges to make the decision of this Court in any proceeding pending before them as a small tax case, has been rendered obsolete by the repeal of the section under which such authority was granted. See section 7463(g), I.R.C. 1954, as repealed by section 105(a)(1)(A) of the Technical Corrections Act of 1979, Pub. L. 96-222, 94 Stat. 194, 218. Special Trial Judges are currently authorized to make the decision of the Court in any proceeding pending before them as a small tax case by virtue of section 7456(d)(2), I.R.C. 1954, as amended, Rule 182(c), Tax Court Rules of Practice and Procedure, Delegation Order No. 8, 81 T.C. XXV, and Amendment 1 thereto, 86 T.C. VIII, and Delegation Order No. 11, 86 T.C. VII.

SAMUEL B. STERRETT
Chief Judge

Dated: Washington, D.C.
February 21, 1986

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UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

DELEGATION ORDER NO. 11

TO: The Special Trial Judges of the Court

Pursuant to section 7456(c) and (d), I.R.C. 1954, as amended, and Rule 182(c), Tax Court Rules of Practice and Procedure, and until further notice, it is

ORDERED that a Special Trial Judge is authorized to make the decision of the Court in any small tax case (as defined in Rule 171) that may be assigned for trial or other disposition. A Special Trial Judge is also authorized to make the decision of the Court in any other case that may be so assigned where neither the amount of the deficiency placed in dispute (within the meaning of section 7463, I.R.C. 1954, as amended), nor the amount of any claimed overpayment, exceeds $10,000. Except in cases where findings of fact or opinion are stated orally pursuant to Rule 152, the decision of the Court in a small tax case shall be made only after the Special Trial Judge prepares a summary of the facts and reasons for the proposed disposition of the case and submits said summary to the Chief Judge, or to another Judge designated by the Chief Judge. In any other case involving $10,000 or less where findings of fact or opinion are not stated orally pursuant to Rule 152, the decision of the Court shall be made only after the Special Trial Judge prepares and submits to the Chief Judge, or to another Judge designated by the Chief Judge, proposed findings of fact and opinion.

This order is effective nunc pro tunc as of January 16, 1984.

SAMUEL B. STERRETT
Chief Judge

Dated: Washington, D.C.
February 21, 1986

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UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

DELEGATION ORDER NO. 8

Amendment 1

To: The Special Trial Judges of the Court

Pursuant to section 7456(c) and (d), I.R.C. 1954, as amended, and until further notice, it is

ORDERED that Delegation Order No. 8 (81 T.C. XXV), issued July 1, 1983, is amended, nunc pro tunc as of July 1, 1983, by substituting the amount "$10,000" for the amount "$5,000" in the penultimate paragraph thereof. It is further

ORDERED that the above-referenced Delegation Order is also amended, effective this date, by striking therefrom the last three sentences of the last paragraph and substituting the following:

If action on the motion would be dispositive of the case, the Special Trial Judge shall prepare in his or her own name an appropriate opinion, memorandum opinion, or memorandum sur order and submit it for approval to the Chief Judge or other Judge designated by the Chief Judge. Thereafter the Special Trial Judge is authorized to make the decision of the Court. On the other hand, if action on the motion would not be dispositive of the case, any opinion or memorandum opinion should be prepared in the name of the Special Trial Judge and submitted to the Chief Judge or other Judge designated by the Chief Judge. Memorandums sur order which are not dispositive of the case need not be submitted to the Chief Judge except in instances where a sensitive issue is involved.

SAMUEL B. STERRETT
Chief Judge

Dated: Washington, D.C.
February 21, 1986

UNITED STATES TAX COURT

WASHINGTON, D.C. 20217

GENERAL ORDER NO. 2

Supplement 13

The name of Judge Julian I. Jacobs is added to the list of alternate designees to Judge Mary Ann Cohen with respect to the Small Tax Case Division of the United States Tax Court nunc pro tunc as of June 12, 1985. The name of Judge William M. Fay is deleted from said list nunc pro tunc as of May 14, 1985.

SAMUEL B. STERRETT
Chief Judge

Dated: Washington, D.C.
February 21, 1986

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INTEREST

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INTEREST—continued

loan probably would be necessary to satisfy its future economic needs, which were of an ordinary, recurrent nature, Court determined on facts and under case law, interest was nondeductible interest paid on "indebtedness incurred or continued to purchase or carry" tax-exempt securities within the meaning of sec. 265(2). ***Earl Drown Corp. v. Commissioner*** 217

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REPORTS

OF THE

UNITED STATES TAX COURT

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9428-83. Filed February 6, 1986.

BASIN was merged into NL, a publicly held company, under a plan of reorganization which satisfied the requirements of sec. 368(a)(1)(A) and (a)(2)(D), I.R.C. 1954. Petitioner husband as sole shareholder of BASIN received stock and cash in exchange for his stock in BASIN. The cash constituted "boot" under sec. 356(a)(1), I.R.C. 1954. *Held*: The distribution of the "boot" did not have the effect of a dividend under sec. 356(a)(2), I.R.C. 1954. The test of *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), rather than the test of *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), applied.

Walter B. Slocombe, *Daniel B. Rosenbaum*, and *Daniel M. Davidson*, for the petitioners.

Kathleen E. Whatley, for the respondent.

TANNENWALD, *Judge*: Respondent determined a deficiency in petitioners' Federal income taxes for the taxable year 1979 of $972,504.74. The sole issue for decision is whether the receipt by petitioners of cash (boot) as partial consideration under a plan of reorganization pursuant to sec. 368(a)(1)(A) and (a)(2)(D),[1] should be treated as a dividend pursuant to sec. 356(a)(2), instead of long-term capital gain under sec. 356(a)(1).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits.

Petitioners, husband and wife, resided in Buckhannon, West Virginia, at the time they filed their petition in this case. They timely filed a joint Federal income tax return for the calendar year 1979 with the Internal Revenue Service Center in Memphis, Tennessee.

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

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For some time prior to April 18, 1979, petitioner husband Donald E. Clark (hereinafter referred to as petitioner) owned all the outstanding stock (58 shares) of Basin Surveys, Inc. (BASIN), a West Virginia corporation. BASIN's principal business was furnishing radiation, nuclear, and electronic open-hole logging services to the petroleum industry. Petitioner was the president of BASIN from 1964 until April 18, 1979.

N.L. Industries, Inc. (NL), is a New Jersey corporation engaged in the manufacturing and supplying of petroleum equipment and services, chemicals, and metals. NL is a publicly held corporation whose stock is traded on the New York Stock Exchange and the Pacific Stock Exchange. As of the end of March 1979, NL had outstanding approximately 32,533,000 shares of its single class of common stock (par value $2.50 per share) and 500,000 shares of preferred stock. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL.

In 1978, NL initiated discussions with petitioner regarding the possible acquisition of BASIN by NL. After several months of negotiations, on March 6, 1979, NL offered petitioner a choice between two alternatives: in exchange for petitioner's BASIN stock, NL was willing to give petitioner either (1) 425,000 shares of NL common stock and no cash, or (2) a combination of 300,000 shares of common stock and $3,250,000 cash. Petitioner accepted NL's combined stock and cash offer. By accepting this offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and petitioner's stockholdings represented approximately 0.92 percent of that total. If petitioner had accepted the all-stock deal of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and petitioner's stockholdings would have represented approximately 1.3 percent of that total.

On April 3, 1979, an agreement and plan of merger (the plan) was executed by BASIN, NLAC, petitioner, and NL. The plan provided that on April 18, 1979, BASIN would merge with and into NLAC and that each outstanding share of NLAC would remain outstanding, each outstanding share of BASIN common stock would be exchanged for $56,034.482 cash and 5,172.4137 shares of NL common stock, and each

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share of BASIN common stock held in the treasury of BASIN would be canceled. The plan further provided that the articles of incorporation of NLAC would be amended to change its name to Basin Surveys, Inc. Moreover, pursuant to the plan, petitioner signed a covenant not to compete for 5 years and an employment agreement to remain with Basin Survey, Inc., for 3 years.

For the purposes of this case, the parties agree that the merger of BASIN into NLAC (the merger) was effected pursuant to, and qualified as a reorganization under, section 368(a)(1)(A) and (a)(2)(D). The closing price of NL common stock on the New York Stock Exchange on April 18, 1979, was $23⅛ per share. Based on that closing price, the NL stock received by petitioner had a value of $6,937,500 which constituted 68.1 percent of the total value of the consideration which petitioner received for his BASIN stock. Prior to the merger, petitioners did not own any stock in NL or NLAC.

Petitioner's basis for his BASIN stock immediately prior to the merger was $84,515. He incurred expenses of $25,013 in connection with the merger. In their joint Federal income tax return for 1979, petitioners reported recognition of $3,195,294 of long-term capital gain as a result of the merger. As of April 18, 1979, BASIN had accumulated undistributed earnings and profits of $2,319,611, and total assets of $2,758,069 and liabilities of $808,132. Among its assets were $138,490 in cash, $1,231,552 in trade notes and accounts receivable (after allowance for bad debts), and buildings and other fixed depreciable assets with a book value net of accumulated depreciation of $929,306.

OPINION

The issue for decision is whether the cash (boot) received by petitioner had the effect of a dividend under section 356(a)(2), and should therefore be taxed as ordinary income. Resolution of this issue requires us to choose between two judicially articulated tests (the so-called *Wright* test, *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), and the so-called *Shimberg* test, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. (1978)), in interpreting what is, at best, an ambiguous statute. Respondent argues that we should

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choose the *Shimberg* test and treat the $3,250,000 cash payment as if it constituted a distribution in redemption of stock by the *acquired* corporation (BASIN) prior to, and separate from, the merger. If this is our choice, then, according to respondent, since the redemption fails to satisfy the requirements of either section 302(b)(1) or (b)(2), the cash payment should be treated as a dividend from BASIN under section 356(a)(2) to the extent of its earnings and profits ($2,319,611), and as capital gain in respect of the excess.[2] Petitioner, on the other hand, urges us to choose the *Wright* test and treat the cash payment as a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration under the all-stock alternative available to him. Petitioner then argues that such a redemption would have resulted in a meaningful or substantially disproportionate reduction in petitioner's stock interest in NL and that consequently, the entire $3,250,000 cash payment should be treated as a payment in exchange for NL stock, under section 302(a),[3] taxable as capital gain under section 356(a)(1). For the reasons hereinafter set forth, in the context of this case, we agree with petitioners.

The issue of choice is not a novel one, although as will subsequently appear, the number of judicial precedents is limited. It has spawned a large number of articles and commentaries of both an historical and analytical nature[4] dealing with the proper test to be used in applying section

[2]Since the amount of the cash is not in excess of petitioner's gain from the exchange, the limitation of sec. 356(a)(1) does not come into play. We note that for the same reason, this limitation does not apply to the *Wright* test advocated by petitioner.

[3]The general rule of sec. 302(a) provides that "If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock."

[4]See Kyser, "The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)," 39 Tax L. Rev. 297 (1984), and citations collected at p. 299, nn. 14 & 15; Rands, "Section 356(a)(2): A Study o. Uncertainty in Corporate Taxation," 38 U. Miami L. Rev. 75 (1983); Levin, Adess & McGaffey, "Boot Distributions in Corporate Reorganizations - Determination of Dividend Equivalency," 30 Tax Law. 287 (1977); Golub, "'Boot' in Reorganizations - The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904 (1980); Comment, "Determining Dividend Equivalence of 'Boot' Received in a Corporate Reorganization," 32 Tax Law. 834 (1979). See also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 14.34, at 14-116 to 14-119 and S14-53 to S14-56 (4th ed. 1979 & Supp. 1985); D. Kahn, Basic Corporate Taxation, par. 10.51 (3d ed. 1981).

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356 to acquisitive reorganizations.[5] While we deem it unnecessary to lay out a detailed, evolutionary history, a brief review of the statutory provisions and their historical genesis appears to be in order as a prerequisite to understanding the parameters of the choice we are called upon to make.

Sections 354 and 356 provide the tax treatment to be afforded shareholders of corporations which are parties to reorganizations qualifying as such under section 368(a)(l). Specifically, under section 354(a)(1)—

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, *exchanged solely for the stock or securities in such corporation or in another corporation a party to the reorganization.* [Emphasis added.]

In situations in which the reorganization is not a straight stock-for-stock deal, but instead includes some additional consideration, the Internal Revenue Code (the Code) does not simply recategorize the entire transaction as a taxable exchange. Rather, it provides for a limited recognition of gain under section 356(a)(1)—

> (1) RECOGNITION OF GAIN.—If—
>
> (A) section 354 or 355 would apply to an exchange but for the fact that
>
> (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,
>
> then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

This gain is to be treated as a capital gain unless the exchange qualifies for dividend treatment under section 356(a)(2), which provides—

---

[5] Since sec. 368(a)(1)(E) (recapitalization) and (F) (mere change in identity, form, or place of organization) only involves a single corporation, a choice between the *Wright* test and the *Shimberg* test is not required. Similarly, in view of the "solely" requirement of sec. 368(a)(1)(B) (see *Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980), revg. and remanding *Pierson v. United States*, 472 F. Supp. 957 (D. Del. 1979), and *Reeves v. Commissioner*, 71 T.C. 727 (1979); and *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980), revg. and remanding *Reeves v. Commissioner*, *supra*), there never should be any "boot" and hence no occasion for choice where a "B" reorganization is involved. See also *McDonald v. Commissioner*, 52 T.C. 82 (1969), where a choice was made because respondent erroneously conceded the existence of a "B" reorganization (see Rev. Rul 75-360, 1975-2 C.B. 110).

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If an exchange is described in paragraph (1) but *has the effect of the distribution of a dividend* * * * then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property. [Emphasis added.]

The precursor of section 356(a)(2) first appeared in the Revenue Act of 1924, which became, without significant change, section 112(c)(2) of the Internal Revenue Code of 1939. The following example, found in the report of the House Ways and Means Committee, is illuminating—

The necessity for this provision may best be shown by an example: Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.

On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain. Here again this provision prevents evasions.

[H. Rept. 179, 68th Cong., 1st Sess. 15 (1924), 1939-1 C.B. (Part 2) 241, 252.]

Thus, it appears that the primary objective of Congress was to prevent shareholders from bailing out earnings and profits at capital gain rates when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization, i.e., "to prevent the bailout of earnings and profits at capital gains rates through the device of a reincorporation reorganization." See Kyser, *supra* note 4, at 302.

In *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), the Supreme Court ruled that any distribution of "boot" pursuant to a reorganization would have the effect of a taxable dividend to the extent of the corporation's

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accumulated earnings and profits, i.e., the so-called "automatic dividend rule." That decision met with much criticism, however (see, e.g., *Hawkinson v. Commissioner*, 235 F.2d 747, 750-751 (2d Cir. 1956)), and both the courts and the Internal Revenue Service have now retreated from the rule. See, e.g., *Shimberg v. United States*, 577 F.2d at 290; *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 418 F.2d 511, 520 (1969); *Johnson v. Commissioner*, 78 T.C. 564, 575-576 (1982); Rev. Rul. 74-515, 1974-2 C.B. 118, 120.

In its place, the courts have developed a concept which encompasses the determination of whether a distribution has "the effect * * * of a dividend" by looking to the provisions of section 302, although there is no express reference to that section in section 356(a)(2). Most of the courts have said that these two sections are to be read in pari materia. *Wright v. United States*, 482 F.2d at 605; *King Enterprises, Inc. v. United States*, 418 F.2d at 520; *Ross v. United States*, 146 Ct. Cl. 223, 173 F. Supp. 793, 797 (1959); *Hawkinson v. Commissioner*, *supra* at 751. The Fifth Circuit Court of Appeals, however, has adopted a somewhat more ambiguous approach by embracing and considering section 302 simply as providing " 'in appropriate cases' * * * 'useful guidelines for purposes of applying section 356(a)(2).' " *Shimberg v. United States*, *supra* at 287 n. 13. (Citation omitted.) Although Congress has not chosen specifically to amend the Code to reflect the interrelationship of these two sections, its acquiescence and tacit approval of such a conclusion is apparent in the Conference Committee Report for the Deficit Reduction Act of 1984, in which it was unequivocally stated that "The principles of section 302 are applicable in testing for dividend equivalency under section 356." H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 1, 99. Furthermore, the Internal Revenue Service has adopted this position in its published rulings.[6] In point of fact, the distinction between the "in pari materia" and the "useful guidelines" standard is little more than one of nuance and without any impact on the instant case since neither standard provides any significant help in making the choice before us.

[6]See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 75-83, 1975-1 C.B. 112.

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Turning to section 302(b), we find two situations, insofar as relevant to the case before us, in which a distribution in redemption of stock is to be treated as a distribution in part or full payment in exchange for such stock and not as a dividend. Section 302(b)(1) provides for such treatment, i.e., capital gain under section 302(a), "if the redemption is not essentially equivalent to a dividend." The Supreme Court has held that for a redemption to meet this test it "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis*, 397 U.S. 301, 312 (1970). Section 302(b)(2)(A) provides for such treatment if the "distribution is *substantially disproportionate* with respect to the shareholder." (Emphasis added.) A distribution qualifies as being "substantially disproportionate" if the shareholder's interest in the voting stock and the common stock (whether voting or nonvoting) of the corporation immediately after the redemption is less than 80 percent of his interest in such stock immediately before the redemption, and if immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. Sec. 302(b)(2)(B) and (C). If the shareholder falls within this "safe harbor" constructed by Congress, the redemption is deemed to be "substantially disproportionate."

The first case[7] directly to confront the issue of whether, in determining the application of section 356(a)(2), the tests under section 302 should be applied in the context of a redemption by the *acquired* or the *acquiring* corporation was *Wright v. United States*, *supra*, in which the Eighth Circuit Court of Appeals held that the proper test for determining whether the distribution had "the effect * * * of a dividend" was to view the cash payment as a reduction of the taxpayer's stockholdings in the *acquiring*, i.e., surviving, corporation. In Rev. Rul. 75-83, 1975-1 C.B. 112,

[7] In *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 418 F.2d 511 (1969), there was no dispute that the dividend determination should be made with reference to the acquired corporation. See 418 F.2d at 521. In *Ross v. United States*, 146 Ct. Cl. 223, 173 F. Supp. 793 (1959), the Court of Claims thought the facts of that particular case so clear that it had no choice but to find that the distribution was made by the acquired corporation. *Hawkinson v. United States*, 235 F.2d 747 (2d Cir. 1956), seemingly determined dividend equivalency in terms of a distribution from the acquired corporation but clearly did not confront the issue of choice between the acquired and the acquiring corporation. See also pp. 151-152, and particularly *infra* note 15, discussing *McDonald v. Commissioner*, 52 T.C. 82 (1969).

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however, the respondent expressly rejected the holding in *Wright* and said it would not be followed. Instead, respondent focused on the cash payment as a reduction of the taxpayer's stockholdings in the acquired corporation, prior to the reorganization. The Fifth Circuit Court of Appeals adopted a similar stance in *Shimberg v. United States*, *supra*, in which it also rejected the holding and reasoning of *Wright* as erroneously placing the emphasis on the surviving, instead of the acquired, corporation. See 577 F.2d at 287.

Wright v. United States, *supra*, involved the consolidation of two closely held corporations into a new corporate entity (Omni). The old corporations were commonly owned, but in different proportions. A simple merger involving the exchange of shares of these corporations for shares of Omni would not have resulted in the ownership percentages in Omni desired by the controlling shareholders. As a result, pursuant to the reorganization, "boot," in the form of a promissory note, was paid to the majority stockholder to compensate him for taking a reduced equity interest in Omni.

In determining dividend equivalency, the Eighth Circuit first focused on who in fact issued the note constituting the "boot," i.e., the old corporations or Omni. While recognizing that "it is not material whether the distribution is actually made by the corporation entering the reorganization or by the corporation resulting from the reorganization," the court emphasized that it could not ignore "the factual circumstance that there were two corporations * * * before reorganization and one after reorganization." 482 F.2d at 607. The court found that, within the context of the entire plan of reorganization, it was artificial for respondent to contend that the note was issued by the old corporations. Instead the court held that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni." 482 F.2d at 607. The court concluded that the rationale underlying the redemption provisions mandated such a result—

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The entire concept of a redemption contemplates a change in ownership between an ongoing corporation and a newly formed corporation or within an ongoing corporation itself. For example, underlying the "safe harbor" provision, sec. 302(b)(2), is the rationale that a substantially disproportionate redemption of stock leads to the conclusion that the exchange is a redemption. The percentage requirements, e.g. the 50 per cent rule, refers to the necessity of having 50 per cent of the total voting stock *after redemption*. This rule and other redemption provisions make sense only in relation to a corporation that will continue to exist. If a substantially disproportionate redemption of stock has occurred the distribution clearly can be said to be a sale rather than a dividend because the stockholder has relinquished valuable rights in the future business. Further, the rights of stock ownership—to vote, to participate in earnings, and to share in net assets on liquidation—are all affected by a redemption. But these rights and the effect of a redemption only make sense in relation to a corporation that will be engaged in doing business after the redemption. To analyze the present case as a redemption of [the old corporations'] stock alone * * * is an artificial reading of the redemption provisions, for [the old corporations] were dissolved as part of the Plan. The change in ownership that would be significant due to a redemption would be a change in ownership in Omni, the corporation that would exist after the redemption and would have voting stock, earnings, and assets that would be affected. [482 F.2d at 607-608. Emphasis supplied.]

In *Shimberg v. United States*, *supra*, the Fifth Circuit Court of Appeals was faced with a factual set of circumstances similar to the instant case. The taxpayer in that case owned approximately 67 percent of a LaMonte-Shimberg Corp. (LSC), of which he was president and chief executive officer. Pursuant to a plan of reorganization, LSC was merged into a large publicly held corporation called MGIC Investment Corp. (MGIC) whose stock was traded on the New York Stock Exchange. According to the terms of the merger, the stockholders of LSC received ratably, in exchange for all their LSC stock, stock of MGIC and cash "boot" of $625,000. The taxpayer received $417,449 in cash and stock in MGIC constituting less than 1 percent of MGIC's total shares outstanding. Immediately prior to the merger, LSC had undistributed earnings and profits in excess of $625,000.

As in *Wright*, the issue before the Fifth Circuit was whether the taxpayer's receipt of cash "boot" had the effect of a dividend distribution. The District Court had found for the taxpayer, basing its decision on an apparent misinter-

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pretation of the holding in *Wright*. *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976). After a preliminary discussion of the Eighth Circuit's application of the *Davis* "meaningful reduction" test in *Wright*, the District Court concluded that the taxpayer's relinquishment of ownership and control of a small, local company in exchange for a "miniscule percentage of the outstanding stock of a huge, publicly-held corporation [made it] * * * clear that the merger resulted in a radical change and meaningful reduction in the nature of the [taxpayer's] interest in the continuing business." 415 F. Supp. at 836. Thus, rather than focusing solely on the taxpayer's interest in the surviving corporation, the District Court misconstrued *Wright* to mean that the proper test for determining dividend equivalency was a comparison between the taxpayer's interest in the acquiring, i.e., surviving, corporation after the reorganization and the interest he held prior to the reorganization in the acquired corporation.

The Fifth Circuit Court of Appeals reversed, finding that the District Court's application of the "meaningful reduction" test of section 302(b)(1) was incorrect and that the "undifferentiating invocation of stock redemption principles in a reorganization case such as this is erroneous." 577 F.2d at 287. It is apparent that the Court of Appeals predicated its rejection of the lower court's holding on its mistaken view that the District Court had properly interpreted and applied the *Wright* test. This is clearly borne out by the court's finding that—

> A contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in *Wright*— could result in a meaningful reduction. [577 F.2d at 288.[8]]

[8] The Fifth Circuit's misunderstanding of the *Wright* holding is even more clearly evidenced in *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). In that case, pursuant to a plan of reorganization qualifying as such under sec. 368(a)(1)(C), the two shareholders of Olivier Co., Inc. (Olivier), who held two-thirds and one-third of its stock, respectively, received pro rata cash payments and stock of U.S. Industries (USI), constituting 0.4 percent and 0.2 percent, respectively, of the total outstanding stock of USI. The Fifth Circuit, in discussing the decision in *Wright*, stated—

> "Here, if the *Wright* test were applicable, we would be concerned with a reduction from a 66⅔% and 33⅓% interest in Oliver stock for [the two shareholders] respectively to a 0.4% and

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Having rejected the District Court's analysis, the Fifth Circuit reasoned that, according to the theory and legislative history behind the reorganization provisions "section 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." 577 F.2d at 288. It then concluded that, since absent the reorganization, a pro rata distribution of $625,000 to LSC shareholders would have been a dividend taxable as ordinary income, "The taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger in the form of a dividend." 577 F.2d at 289.

After careful consideration, we have concluded that, at least in the context of the factual situation before us, the *Wright* test is the better choice in respect of the application of section 302 to the determination of whether "boot" has "the effect of the distribution of a dividend" under section 356(a)(2). Several considerations have led us to this conclusion.

The genesis of section 356(a)(2) (see p. 143 *supra*), lay in Congress' concern for the possibilities of manipulated withdrawals within the framework of reorganizations which approached the types of transactions which have been dealt with in later years through the application of the liquidation-reincorporation doctrine. See B. Bittker & J. Eustice, *supra* note 4, par. 14.54.[9]

While we recognize this clear intent by Congress to prevent abusive cash bailouts made pursuant to planned reorganizations, as well as the fact that the language used in section 356(a)(2) may have been broader than necessary to deal with the legislative concern, contrary to respondent's position we do not think it follows that we must test "boot" distributions in connection with a reorga-

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0.2% respective interest in the outstanding USI stock. [615 F.2d at 1066.]"

Once again, the Fifth Circuit misinterpreted the *Wright* test as comparing shareholder interests in the old corporation to those in the surviving corporation.

[9]Subsequent legislative history is of little help in resolving the choice issue. Proposals in 1954 and 1959 seem to have embraced respondent's position herein while more recent proposals embrace the position espoused by petitioner; none of these proposals have been adopted. See Kyser, *supra* note 4, at 322-323; Rands, *supra* note 4, at 93-94; Golub, *supra* note 4, at 905-906; B. Bittker & J. Eustice, *supra* note 4, at S14-51 to S14-56.

nization, as if they were made by the acquired corporation prior to and separate from the reorganization. As we have noted in the past, in legitimate reorganizations that substantially reduce a shareholder's ownership interest, although it may be true "that a decision in favor of the petitioner would allow him to withdraw substantial corporate earnings at no tax (or, if his basis in the redeemed stock were less than the amount distributed, at capital gains rates) * * * such result does not require us to hold that the distribution is a dividend." *McDonald v. Commissioner*, 52 T.C. 82, 89 (1969).

Respondent asks us to follow a twisted path. After conceding that the distribution has been made pursuant to a legitimate reorganization under section 368(a)(1)(A), a necessary prerequisite to invoking section 356(a)(2), respondent then asks us to make our determination of dividend equivalency fantasizing that the reorganization does not exist.[10] Clearly, if Congress had wanted the distribution to be viewed in this manner, it could easily have said so in 1924 or in connection with the passage of numerous revenue acts in the ensuing 60 years.[11]

We reject respondent's attempt to bootstrap the holdings that the acquired corporation's earnings and profits should be the measure of any dividend under section 356(a)(2) into a conclusion that the determination of the requisite reduction in interest under section 302(b) must be necessarily made with reference to the same corporation. In our opinion, there is no such necessary correlation. There is no reason why the redemption cannot be considered as having been made by one corporation with the consequences to be measured by the earnings and profits of another corporation. Compare section 304(b)(1) with section 304(b)(2)(A). Moreover, the courts are not in agreement as to the standard of measurement to be used. See *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 106-107 (1978), affd. 614 F.2d 860, 868 (3d Cir. 1980).[12] Indeed, respondent on brief has

[10] See *supra* note 9 for the conflicting attempts by Congress to deal with the choice issue.

[11] Furthermore, the limitation of dividend treatment contained in sec. 356(a)(2) is a clear indication that Congress considered the boot distribution to be an integral element of the reorganization. See Levin, Adess & McGaffey, *supra* note 4, at 303.

[12] See also *Davant v. Commissioner*, 366 F.2d 874, 887-890 (5th Cir. 1966), revg. on this issue *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540, 570-572 (1965); *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970).

made it clear that his acceptance of the agreed stipulation of the parties that the earnings and profits of BASIN will be the measure of any dividend determined herein is not to be construed as an acceptance of this test in any other case.

Respondent's attempt to view the cash payment as an isolated event totally separate from the reorganization runs counter to the established case-law principle known as the "step-transaction" doctrine—a doctrine which respondent has zealously and generally successfully sought to apply in the reorganization arena. See Levin, Adess & McGaffey, *supra* note 4, at 290; Rands, *supra* note 4, at 117. In *McDonald v. Commissioner*, *supra*, we held that the "step-transaction" doctrine, first set forth in *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954),[13] was "applicable in determining whether a redemption is essentially equivalent to a dividend within the meaning of section 302(b)(1)." 52 T.C. at 87. The facts in *McDonald*, simply stated, are as follows. Taxpayer owned 10 of the 11 shares of the common stock of E & M Enterprises, Inc. (E&M), and all of its preferred stock. Pursuant to a plan of reorganization, E&M redeemed all of taxpayer's preferred stock for $43,500, and Borden Co. (Borden), the corporation acquiring E&M, gave 4,839 of its shares in exchange for the 11 shares of E&M common stock. E&M acquired the cash to carry out the redemption by obtaining a short-term bank loan. A week after the redemption, E&M and Borden exchanged their shares and Borden transferred cash to E&M which was used in part to pay off the loan. Respondent argued that the redemption by E&M of taxpayer's preferred stock was a totally separate transaction and thus taxable as a dividend.[14] In holding for

[13]The taxpayer in *Zenz* wished to sell all the stock in a corporation in which she was the sole stockholder. To satisfy the wishes of the purchaser who did not want to buy all the stock of the corporation, the parties agreed upon a plan under which the purchaser bought part of the stock and the corporation redeemed the remaining shares. The court viewed the steps in the transaction as part a single integrated plan intended to totally liquidate the taxpayer's holdings in the corporation. In light of this, the court held that redemption was not essentially equivalent to a dividend because it completely terminated her interest in the corporation. See 213 F.2d at 917.

[14]It should be noted that, at trial, respondent considered the redemption and exchange to be separate transactions and therefore conceded that the exchange constituted a tax-free reorganization under sec. 368(a)(1)(B). 52 T.C. at 86. However, in Rev. Rul. 75-360, 1975-2 C.B. 110, the respondent recognized that—

"it was in error in arguing the various steps were separate transactions thereby affording tax-free treatment on the stock exchange. Accordingly, since the acquisition was not solely for voting stock of the acquiring corporation, but partly for cash, that the acquisition of stock of

the taxpayer, we recognized that "The record in this case establishes clearly that the *redemption was merely a step in the plan of Borden for the acquisition of E&M, so that it is the results of the plan that are significant to us.*" 52 T.C. at 87 (emphasis added). We concluded that "Taking into account all the circumstances of this case * * * the redemption and the reorganization effected such a substantial change in the petitioner's interest in E&M as to establish that the redemption was not essentially equivalent to a dividend." 52 T.C. at 89.

We recognize that some argument can be made that the same failure to apply the step-transaction doctrine exists in applying the *Wright* test in that such test involves viewing the cash payment as being in redemption of an imputed number of shares of the acquired corporation after the reorganization has occurred. See Rands, *supra* note 4, at 102-103. But we think this argument fails in that the *Wright* test treats the cash payment as the equivalent of a redemption *in the course of implementing the reorganization*, while the *Shimberg* test, advocated by respondent, requires that the redemption by the acquired corporation be treated as having occurred *prior to and separate from the reorganization*. Clearly, the cash payment in situations of the type involved herein would not have taken place without the reorganization. The same cannot be said of the redemption created by the *Shimberg* test.

In view of the foregoing, we conclude that the determination of whether the cash payment to petitioner had "the effect * * * of a dividend" should be viewed and tested within the context of the entire reorganization. To hold otherwise, and view and test the cash (boot) as if it were distributed as a hypothetical redemption by BASIN prior to the reorganization, would in effect resurrect the now discredited "automatic dividend rule" (see pp. 143-144 *supra*), at least with respect to pro rata distributions made to an acquired corporation's shareholders pursuant to a plan of reorganization.

We turn now to the question whether petitioner, as a result of the reorganization, suffered a reduction in interest

E&M did not constitute a reorganization. Therefore * * * the entire transaction is considered a taxable sale or exchange."

sufficient to qualify the cash he received as a redemption under section 302(b). In resolving this question, we apply the test enunciated in *Wright v. United States*, *supra*, and look at the effect of the reorganization on petitioner's potential and actual interest in NL, the acquiring, i.e., surviving, corporation.[15]

Pursuant to the plan, petitioner received 300,000 shares of NL common stock, which constituted approximately 0.92 percent of the total shares outstanding of NL common stock after the merger. If petitioner had accepted the all stock offer, he would have received 425,000 shares of stock, which would have constituted approximately 1.3 percent of NL's total shares outstanding. By treating the cash "boot" as a redemption of petitioner's shares, we find that the cash distribution reduced petitioner's interest in NL by approximately 29 percent (from 1.3 percent to 0.92 percent) so that his post-distribution holdings were only approximately 71 percent of what they would have been absent the distribution. Coupled with the fact that petitioners held less than 50 percent of the voting stock of NL after the redemption, under section 302(b)(2) the distribution qualifies as being "substantially disproportionate" and is not taxable as a dividend. Since the distribution falls within the mechanistic "safe harbor" of section 302(b)(2), we need not decide if the redemption resulted in a meaningful reduction of petitioner's stock interest under section 302(b)(1).

In point of fact, respondent does not argue that the required reduction in petitioner's interest does not exist if the *Wright* test is applied. Rather, the heart of respondent's position is that use of the *Wright* test results in an "automatic capital gain" rule. Respondent argues that, in cases involving factual circumstances similar to the instant case, in which the "whale" swallows the "minnow" and gives the shareholders of the acquired corporation a pro

[15]We recognize that it is possible to construe our opinion in *McDonald v. Commissioner*, 52 T.C. 82 (1969), as adopting a test based upon a comparison of a taxpayer's stock interest in the acquiring corporation with his prior interest in the acquired corporation. However, we think it significant that *McDonald* was decided prior to either *Wright* or *Shimberg*, that the issue before this Court was simply whether the redemption was separate from, or an integral part of, the reorganization, and that it appears that the acquired versus acquiring corporation test for applying sec. 356(a)(2) was not presented to us. Such being the case, and particularly since the result in *McDonald* would have been the same under the *Wright* test, we do not view our opinion in *McDonald* as inhibiting our freedom to choose the test which should be applied herein.

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rata distribution of boot in addition to stock, those shareholders will always be afforded capital gain treatment. He reasons that if a shareholder in a small closely held corporation exchanges his interest in that corporation for what must be, almost by definition, a much smaller percent of ownership in a large publicly held corporation, a comparison of these percentage ownership figures will always be so disparate as to qualify as a meaningful reduction or as substantially disproportionate in the context of a redemption by the acquiring corporation. In effect, respondent's position is rooted, as was that of the District Court in *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976), in an erroneous equating of the *Wright* test with a comparison of a taxpayer's interest in the acquired corporation before the reorganization with his interest in the acquiring corporation after the reorganization. See pp. 147-150 *supra*. We think we have made it clear that the *Wright* test does no such thing. It simply compares the stock interest which a taxpayer actually receives in the acquiring, i.e., surviving, corporation in a reorganization with what he would have received if he had obtained additional stock in lieu of the cash payment. Whether the results of such a comparison indicate dividend or capital gain treatment will vary, depending on the facts and circumstances of each individual case. We think it significant that respondent in substance accepts the facts and circumstances limitation in situations involving section 356(a)(2).[16] In so doing, he reflects the same uncertainties as those of the Fifth Circuit in *Shimberg v. United States*, *supra*—uncertainties which, in a sense, are also present in

[16]We quote from respondent's brief (p. 27):

"We are only addressing in this brief a factual situation which is identical to the one present in *Shimberg* where a small corporation (the "minnow") was merged into a large corporation (the "whale"), there had been no previous commonality of ownership between the two corporations, the "minnow's" shareholders received cash and stock on a pro rata basis, the "minnow's" shareholders stock ownership in the "whale" was very small vis-a-vis the number of shares outstanding, and the acquired corporation had a significant amount of accumulated undistributed earnings and profits."

In connection with the facts and circumstances limitation, we observe that respondent objected at trial to the relevancy of any testimony regarding the merger negotiations. We overruled respondent's objection and reserved to respondent the right to argue the question of admissibility on brief. We are satisfied that we should adhere to our ruling at trial. See *McDonald v. Commissioner*, 52 T.C. 82, 88 (1969).

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our reservation of the same limitation in adopting the *Wright* test.[17]

While we are satisfied that the *Wright* test should not be equated with the comparison erroneously made by the District Court in *Shimberg v. United States*, *supra*, we think that the minnow-whale scenario is a background element which can be taken into account. Cf. *McDonald v. Commissioner*, *supra*. See also *supra* note 15.

If we look at the particular facts and circumstances of the instant case, the correctness of our conclusion that the cash distribution of $3,250,000 did not have "the effect * * * of a dividend" under section 356(a)(2) becomes even clearer. There is not the slightest evidence that the cash payment was a concealed distribution from BASIN.[18] Indeed, it is hard to conceive that such a possibility could even have been considered, for a distribution of that amount was not only far in excess of the accummulated earnings and profits ($2,319,611), but also of the total assets of BASIN ($2,758,069). In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including good will and/or going-concern value, can one possibly arrive at a $3,250,000. Such a distribution could only be considered as the equivalent of a complete liquidation of BASIN, which would call for capital gain treatment under *Zenz v. Quinlivan*, *supra*. Moreover, the record herein makes it clear that it was NL which developed the stock plus cash alternative and that its foundation was attributable to a desire of NL to minimize the number of shares outstanding. In this connection, we think that the question of whether the shareholders of the acquired corporation are given a choice between all stock and stock plus cash in the acquired corporation is not the significant factor. See *McDonald v.*

[17]It is interesting to note that the Court of Appeals in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), would have reached a different conclusion if the attribution rules of sec. 318(a) had been applied. See 482 F.2d at 610. See also Kyser, *supra* note 4, at 312 n. 78. Under sec. 227(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324, 492, the attribution rules of sec. 318 now apply to "boot" payments falling within sec. 356(a).

[18]It is in this context that the facts and circumstances analysis might well produce a different result when there is persuasive evidence of an identity between the amount of the cash payment, the earnings and profits of the acquired corporation, and available liquid assets to support the conclusion that the acquiring corporation was a conduit for the payment. Cf. *Ross v. United States*, *supra* note 7. The problem of identification of the source of a cash payment is not without its difficulties. See Levin, Adess & McGaffey, *supra*, note 4, at 290 n. 15.

Commissioner, *supra* at 89. As a general rule, we would apply the *Wright* test where only the latter offer was available. However, the source of the offer in whatever form may be a fact and circumstance to be taken into account in certain situations. See *supra* note 18.

Our analysis of the issue before us herein has convinced us that neither the *Shimberg* test nor the *Wright* test can be inexorably applied to "boot" distributions in connection with a reorganization, fully within which the ambit of section 356(a)(2). Each test has its supporting and criticizing arguments. See, e.g., Kyser, *supra* note 4; Rands, *supra* note 4; Levin, Adess & McGaffey, *supra* note 4; Comment, *supra* note 4. However, we think that, on balance, the *Wright* test is the more suitable vehicle for decision principally because its application produces a result more within the scope of the type of reorganization Congress had in mind in enacting section 356(a)(2), i.e., where there is an overlapping of ownership between the acquired and acquiring corporations, than the *Shimberg* test which would tend to produce exactly the opposite result. Moreover, unlike the *Wright* test, the *Shimberg* test would make the result dependent upon which corporation, the acquired or the acquiring, survived a merger. Indeed the deficiencies in the *Shimberg* test are sufficient to cause its supporters to suggest that the *Wright* test be applied where there is a "commonality" of ownership of the acquired and acquiring corporations and the *Shimberg* test be reserved for situations where such commonality does not exist. See, e.g., Kyser, *supra* note 4, at 331; Rands, *supra* note 4, at 116. We have difficulty in applying such a bifurcated approach to a statute which seems to make no distinction between different reorganizations. Cf. *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970); Levin, Adess & McGaffey, *supra* note 4, at 306. Furthermore, such an approach would add another difficult dimension to the application of section 356, i.e., determining how much overlap of stock ownership would constitute commonality. See Kyser, *supra* note 4, at 329-332.

One final word. The root of the problem of choice between the *Wright* test and the *Shimberg* test lies in the low level of "continuity of interest" required to constitute a type of

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tax-free reorganization. The result of this low-level requirement is to cause transactions to be treated as reorganizations which really should be considered sales, i.e., where there is a substantial amount of cash paid and/or the stock of the acquiring corporation can be readily disposed of by the taxpayer. See, e.g., Kyser, *supra* note 4, at 315 n. 90 and 340. But this condition has existed far too long for the judiciary now to change the rules of the game. If a change is to come, it must come from the legislature. We think the same is true with respect to adopting a bright-line test, under section 356(a)(2), i.e., a rule applicable without qualification to all cases, to determine whether a distribution has "the effect * * * of a dividend." In the meantime, the courts, the Executive, and taxpayers will be forced to live with a test which admittedly is imprecise in that it will not be inexorably applicable in all situations.

To reflect the foregoing and petitioners' concessions on other issues,

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, GOFFE, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, and WILLIAMS, *JJ.*, agree with this opinion.

SIMPSON, WILBUR, CHABOT, GERBER, and PARR, *JJ.*, did not participate in the consideration of this case.

CENTURY DATA SYSTEMS, INC., THROUGH CALIFORNIA COMPUTER PRODUCTS, INC., SUCCESSOR IN LIQUIDATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2682-84. Filed February 11, 1986.

P at all times relevant herein maintained and closed its books on the basis of a calendar year annual accounting period. P timely filed a separate return on a calendar basis for 1968 and 1969. For 1970, P timely filed a short period separate return for the 6-month period ending June 30, 1970.

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P then joined in the filing of consolidated returns of a group of related corporations. The returns were filed on the basis of fiscal years ended June 30, 1971, and June 30, 1972. R determined P was not an affiliated member and, thus, was not entitled to join in such consolidated returns. R originally issued a statutory notice of deficiency on Dec. 23, 1975, based on P's fiscal years ended June 30, 1970, and June 30, 1971, and P's short taxable year ended Mar. 31, 1972. In an opinion filed Mar. 8, 1983, we held that the Court lacks jurisdiction under sec. 6214(b), I.R.C. 1954, since the notice of deficiency is based on incorrect taxable years.

R subsequently issued a second notice of deficiency on Nov. 7, 1983, in which deficiencies were determined for the years ended Dec. 31, 1970, and Dec. 31, 1971, and short period ending Apr. 3, 1972. There is no dispute that P's correct taxable years are now in issue nor does R challenge P's contention that the statute of limitations had expired prior to Nov. 7, 1983. Rather, R contends that P is equitably estopped from asserting the statute of limitations as a defense to the deficiencies.

Held, P is not equitably estopped from asserting the statute of limitations defense. *Atlas Oil & Refining Corp. v. Commissioner*, 22 T.C. 552 (1954), followed.

James G. Phillipp and *Stephen L. Tolles*, for the petitioner.

Michael C. Cohen, for the respondent.

OPINION

NIMS, *Judge*: This matter is before the Court on petitioner's motion for judgment on the pleadings pursuant to Rule 120.[1] Respondent has submitted, and we have accepted, matters outside the pleadings. We therefore treat petitioner's motion as one for summary judgment pursuant to Rule 121.[2]

Respondent determined deficiencies in petitioner's Federal income tax as follows:

Year ended	*Deficiency*
Dec. 31, 1970	$3,291,164.56
Dec. 31, 1971	3,717,512.59
Apr. 3, 1972	299,377.80

[1]Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954 in effect for the years in question.

[2]Rule 120(b).

The sole issue remaining before the Court is whether petitioner is estopped from raising the statute of limitations as a defense to the determined deficiencies.[3]

For purposes of this motion, all of respondent's factual allegations are deemed admitted. See *DuPont v. Commissioner*, 74 T.C. 498, 501 n. 2 (1980). The following is a summary of those facts revealed by the pleadings and relevant to the inquiry before us.

Petitioner Century Data Systems, Inc. (CDS, hereinafter sometimes petitioner) through California Computer Products, Inc. (Cal Comp), had its principal place of business in Anaheim, California, at the time of filing the petition herein. On or about December 12, 1974, CDS was liquidated, and all of its assets were transferred to and all of its liabilities were assumed by Cal Comp. As such, Cal Comp is joined as a petitioner solely by reason of its status as successor in liquidation to CDS.

Petitioner was incorporated on July 30, 1968, and at all times relevant herein maintained and closed its books on a calendar year annual accounting period. CDS timely filed its Federal income tax returns for the periods ended December 31, 1968, and December 31, 1969, on a separate return, calendar year basis.

On or before March 15, 1971, CDS filed a Federal income tax return reporting its income and deductions on a separate return basis for the 6-month period ended June 30, 1970. Attached to the return was a written statement advising the IRS that such short period return was filed in accordance with section 1.1502-76(c)(2), Income Tax Regs.[4] (relating to separate returns of corporations subsequently to be included on a consolidated return). The balance of petitioner's income and deductions for the remaining 6 months of 1970 and the first 6 months of 1971 were reported and included in Cal Comp's initial consolidated

[3]Respondent has conceded two other issues raised in his answer and addressed by petitioner's motion, to wit: whether the statute of limitations is held open by petitioner's failure to file an appropriate tax return; and whether the statute of limitations has been tolled by the issuance of a prior deficiency notice.

[4]Sec. 1.1502-76(c)(2), Income Tax Regs., reads in pertinent part as follows: "If the group has not filed a consolidated return on or before the due date for the filing of a subsidiary corporation's separate return * * * then on or before such due date such subsidiary shall file a separate return either for the portion of its taxable year for which its income would not be included in a consolidated return if such a return were filed, or for its complete taxable year."

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return for the fiscal year ended June 30, 1971. Petitioner also joined in the consolidated return of Cal Comp for the fiscal year ended June 30, 1972.

From the date of its incorporation, September 17, 1958, through June 30, 1970, Cal Comp filed separate Federal income tax returns on the basis of a fiscal year ended June 30. On or about December 20, 1971, Cal Comp filed its first consolidated Federal income tax return, reporting the income and deductions of Cal Comp, CDS and Cal Comp's five wholly owned U.S. subsidiaries for the fiscal year ended June 30, 1971. Included in this return were schedules which set forth the income, deductions, and credit of CDS for the fiscal year ended June 30, 1971.

On or about March 16, 1973, Cal Comp filed a consolidated Federal income tax return, reporting the income and deductions of Cal Comp, CDS and Cal Comp's six wholly owned U.S. subsidiaries for the fiscal year ended June 30, 1972. Included in this return were schedules which set forth the income, deductions, and credit of CDS for the fiscal year ended June 30, 1972.

Cal Comp claimed net operating losses on its tax returns for the fiscal years ended June 30, 1970, and June 30, 1971. These losses were carried back to prior years resulting in refunds of sufficient magnitude to require review by the Joint Committee on Taxation pursuant to section 6405. Accordingly, respondent assigned Revenue Agent Harold Dey (Dey) to audit Cal Comp's returns.

Dey's audit was for the most part limited to items pertaining to Cal Comp. A cursory inspection of that portion of the consolidated return pertaining to CDS was made. However, Dey did not audit any items on that portion of the return nor did he inspect the books and records of CDS. On October 31, 1972, Dey submitted his revenue agent's report substantially sustaining the claimed refunds. The report did not raise any issue as to whether Cal Comp's control of CDS was sufficient to entitle the two corporations to file on a consolidated basis for the fiscal year ended June 30, 1971.

In the course of evaluating Dey's report, a member of the review staff noticed that the June 30, 1971, consolidated return indicated that Cal Comp owned only 65.8 percent of

CDS's stock, a degree of control insufficient to entitle the two corporations to file a consolidated return.[5] The reviewer requested Dey to investigate the apparent discrepancy.

Dey's investigation culminated with a letter to Dey dated January 23, 1973, sent by Arnold Magasinn (Magasinn), Cal Comp's attorney, which included a statement by Charles H. Sword (Sword), senior vice president and secretary of Cal Comp. In the statement, dated October 11, 1972, Sword affirmed that for fiscal year ended June 30, 1971, Cal Comp had 98-percent control of CDS.[6] Dey accepted this statement from Sword as being dispositive of the issue. Accordingly, a letter recommending approval of the refunds was sent to the Joint Committee on Taxation. The committee's approval was granted on May 29, 1973.

Subsequently, Revenue Agent James Zeitz (Zeitz) was assigned to audit Cal Comp's tax return for the year ending June 30, 1972. In reviewing the corporate minutes for that fiscal year, Zeitz noticed entries dated July 17, 1971, and August 31, 1971, which indicated that Cal Comp was contemplating increasing its ownership of CDS from 65.8 percent to 93.7 percent. After verifying the content of the minutes and securing a copy of Dey's earlier report, Zeitz prepared a Reopening Memorandum (Form 4505) for the June 30, 1971, fiscal year contesting CDS's qualification to be included in Cal Comp's consolidated return.

Zeitz's request for reopening obtained final approval on June 10, 1974. Based on the schedules attached to Cal Comp's tax return, Zeitz concluded that the reopening could

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[5]Sec. 1501 provides: "An affiliated group of corporations shall * * * have the privilege of making a consolidated return * * * in lieu of separate returns."

Under sec. 1504, an affiliated group means one or more chains of includable corporations connected through stock ownership with a common parent if—

(1) Stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

[6]Our examination of Sword's statement reveals an ambiguity as to whether Cal Comp was including the options to purchase additional CDS stock in the 98-percent figure. In any event, petitioner concedes for purposes of this motion that respondent's characterization of the statement as false and misleading must be accepted by the Court as correct.

be accomplished without an additional inspection of the books of Cal Comp or CDS.[7]

On August 7, 1974, Magasinn, authorized to represent both Cal Comp and CDS, executed a Form 872 extending the period for assessment of taxes due under the June 30, 1971, return of Cal Comp to December 31, 1975. Respondent executed the form on August 9, 1974.

On April 3, 1975, a "30-day letter" was sent to CDS setting forth proposed deficiencies for the taxable fiscal years ended June 30, 1970, June 30, 1971, and March 31, 1972. The basis of these deficiencies was that CDS was not properly includable in Cal Comp's consolidated return until Cal Comp's control of CDS had increased to 93.7 percent. A formal protest was filed by petitioner on June 3, 1975. The protest did not include any contention that the proposed deficiencies were for erroneous taxable years, nor did it state any facts from which such a contention could reasonably be drawn. In November 1975, a District conference was held and at no time during the course of this conference did petitioner's representatives contend that the proposed deficiencies were for erroneous tax years.

Respondent issued a statutory notice of deficiency on December 23, 1975, wherein respondent determined deficiencies against CDS for the taxable years ended June 30, 1970, June 30, 1971, and March 31, 1972. Respondent's determination was based on the position that CDS had been erroneously included in Cal Comp's consolidated returns. At the time the deficiency notice was mailed, respondent had no knowledge that it was for the wrong taxable years.

On March 15, 1976, CDS timely filed a petition in this Court for redetermination of the deficiencies determined in the December 23, 1975, deficiency notice. Nowhere in its 18-page petition did CDS contend that the deficiencies had been determined for erroneous taxable years. Almost 3 years later, on approximately January 25, 1979, new counsel entered the case on behalf of CDS and for the first time raised the contention that the deficiencies were for erroneous taxable periods.

[7] On brief, respondent argues that the restrictions imposed on him under sec. 7605(b) (written notice to taxpayer before a second inspection of books) magnified the effect of Sword's misrepresentation. We note, however, the inapplicability of sec. 7605 regarding CDS since a first inspection of CDS's books was never made.

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Subsequently, a motion for judgment on the pleadings was filed by petitioner, contending that the deficiencies were for erroneous taxable years. On March 8, 1983, in *Century Data Systems, Inc. v. Commissioner*, 80 T.C. 529 (1983) (hereinafter *Century Data I*), we granted petitioner's motion, finding that respondent's statutory notice of deficiency was invalid. On March 11, 1983, this Court entered an order dismissing the case for lack of jurisdiction. As more fully explained in the Court's opinion in support of its order, we determined that inasmuch as CDS had continued to keep its books on a calendar year basis and did not become a member of the Cal Comp affiliated group until April 3, 1972, CDS had no separate taxable years ended June 30, 1970, June 30, 1971, and March 31, 1972. Rather, petitioner's correct taxable years were December 31, 1970, December 31, 1971, and April 3, 1972. 80 T.C. at 531 (*Century Data I*).

The Commissioner declined to appeal the Court's order dismissing the case and the order became final on June 9, 1983. On November 7, 1983, respondent issued a second notice of deficiency to CDS. In accordance with this Court's determination as to petitioner's correct taxable years, this notice determined deficiencies for the years ended December 31, 1970, December 31, 1971, and April 3, 1972. The basis of these deficiencies is that CDS was erroneously included in Cal Comp's consolidated returns for the fiscal years ended June 30, 1971, and June 30, 1972.

On February 1, 1984, CDS timely filed the petition herein contesting the deficiencies and raising the statute of limitations as a defense. Shortly thereafter, petitioner filed the instant motion for judgment on the pleadings. Respondent is now confronted with the argument that the assessment of the determined deficiencies is barred by the statute of limitations. In his answer to the petition, respondent contended that petitioner was equitably estopped from raising the statute of limitations as a bar to assessment. Alternatively, he alleged that the statute of limitations did not bar the assessment of the deficiencies.

On brief, respondent concedes that the statute of limitations had expired prior to the issuance of the second statutory notice of deficiency but continues to maintain

that petitioner is nevertheless equitably estopped from raising the statute of limitations defense. Respondent's argument is twofold: first, that petitioner made a false and misleading statement, through its senior vice president (Sword), which caused respondent to issue a statutory notice of deficiency for erroneous taxable years; and second, that petitioner misled respondent by remaining silent as to the correct taxable years, where, but for petitioner's "misleading stony silence," a valid statutory notice could have been issued prior to the expiration of the statute of limitations.

Conversely, petitioner, relying on *Atlas Oil & Refining Corp. v. Commissioner*, 22 T.C. 552 (1954) (hereinafter *Atlas Oil II*), and a long list of other cases, contends that respondent's assessments are long barred by the statute of limitations and that petitioner is not equitably estopped from asserting the same. Petitioner, in the procedural context of this motion, accepts respondent's allegation that Sword's statement was false and misleading but, nevertheless, argues that the statement in no way caused respondent's failure to issue a correct statutory notice of deficiency in a timely manner. Moreover, the blame for respondent's failure to ascertain petitioner's correct taxable years must lie with respondent's own agents for failing to examine the books and records of CDS which were readily available. Petitioner contends that there is no affirmative obligation to correct mistakes made by respondent when, as here, petitioner did nothing to facilitate the mistake.

In spite of respondent's attempts to distinguish this case from *Atlas Oil II*, we conclude that this case is materially indistinguishable and therefore compels the identical result. Accordingly, we hold that petitioner is not equitably estopped from asserting the statute of limitations defense.

The facts of *Atlas Oil & Refining Corp. v. Commissioner*, 17 T.C. 733 (1951) (hereinafter *Atlas Oil I*), and *Atlas Oil II* may be briefly summarized as follows. Shortly after the taxpayer in *Atlas Oil I* incorporated, it adopted through its bylaws a fiscal year ended November 30. However, in conforming with Interstate Commerce Commission regulations, the taxpayer formally closed its books on December 31, 1942, and December 31, 1943. The taxpayer filed its

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1942 and 1943 Federal income tax returns on a fiscal year basis. Respondent subsequently determined deficiencies in petitioner's fiscal years ended November 30, 1942, and November 30, 1943. The Court found that the taxpayer's books were indeed kept on a calendar year basis. The Court then entered decisions for the taxpayer since the deficiencies were incorrectly determined on a fiscal year basis. 17 T.C. at 740 (*Atlas Oil I*).

Respondent did not appeal the decision in *Atlas Oil I*, but rather issued new notices of deficiencies for the correct taxable years ended December 31, 1942, and December 31, 1943. We held that the statute of limitations barred the assessment of the determined deficiencies. 22 T.C. at 561 (*Atlas Oil II*).

In *Century Data I* we followed *Atlas Oil I* stating that "On substantially identical facts and in a Court-reviewed opinion, this Court held it is without jurisdiction to redetermine a deficiency for the incorrect taxable years." 80 T.C. at 532 (*Century Data I*). Respondent's response to *Century Data I* is identical to his response to *Atlas Oil I*; i.e., the issuance of a new statutory notice of deficiency for the correct taxable years. Here, as in *Atlas Oil II*, respondent is confronted with the argument that the assessment of such deficiencies is barred by the statute of limitations.

Respondent has limited his argument in this case to the single contention that petitioner is equitably estopped from asserting the statute of limtations. In *Atlas Oil II* we found for the taxpayer on this issue, stating that "we can find no error or wrong committed by the taxpayer which can form the basis for the application of estoppel." 22 T.C. at 559.

For a court to apply the doctrine of equitable estoppel: "(1) there must be false representation or wrongful misleading silence; (2) the error must originate in a statement of fact, not in opinion or a statement of law; (3) the one claiming the benefits of estoppel must not know the true facts; and (4) that same person must be adversely affected by the acts or statements of the one against whom an estoppel is claimed. [*Lignos v. United States*, 439 F.2d 1365, 1368 (2d Cir. 1971).]" *Piarulle v. Commissioner*, 80 T.C. 1035, 1044 (1983). It is fundamental to the doctrine of

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estoppel that the party raising the issue must have been misled in reliance upon the representations of his opponent. *Piarulle v. Commissioner*, 80 T.C. 1035, 1044 (1983). To be estopped from asserting the statute of limitations, petitioner must be shown to have taken some action which led respondent to postpone until after the statute expired the issuance of a deficiency notice that he was otherwise prepared to mail on a timely basis. *Stearns Co. v. United States*, 291 U.S. 54 (1934); see 22 T.C. at 559 Atlas Oil II).

Respondent raises two factual distinctions between the present case and *Atlas Oil II*. First, affirmative misrepresentation of the type made by CDS through its officer Sword was not present in *Atlas Oil II*. Second, unlike *Atlas Oil II*, where the taxpayer argued and respondent rejected the contention that the taxpayer was on a calendar year basis, CDS failed to contend that its tax liability should be computed on the basis of calendar years until long after the expiration of the statute of limitations, despite several opportunities to make such contention. Thus, respondent asserts that he is not seeking to overturn *Atlas Oil II*, but rather is "only trying to walk in the door which the case clearly left open."

Respondent's first argument is defective in several respects. To begin with, the affirmative misrepresentation complained of goes only to the question of whether CDS was properly included in Cal Comp's consolidated return, not to the question of the correct taxable years. The defect in the original deficiency notice resulted from the erroneous determination of deficiencies computed on a fiscal year basis when petitioner had in fact closed its books on a calendar year basis. 80 T.C. at 537 (*Century Data I*). The manner and time in which petitioner closes its books are dispositive of the correct taxable year issue, irrespective of the includability or excludability of CDS on Cal Comp's consolidated return. 80 T.C. at 537 (*Century Data I*); accord 17 T.C. at 739 (*Atlas Oil I*).

Further, respondent's argument does not comport with his own allegations of fact. Specifically, respondent refused to accept the representation of Sword well in advance of the expiration of the statute of limitations.[8] In fact, it was

[8]For purposes of this motion, we accept respondent's calculation as to the statute of

precisely respondent's "non-reliance" on Sword's statement which led to the Reopening Memorandum, the "30-day letter" and the December 23, 1975, notice of deficiency. Having refused to accept the misrepresentation, respondent cannot now argue that he relied to his detriment on such misrepresentation.

Finally, regardless of any affirmative misrepresentation, the original notice of deficiency was timely issued by respondent. Since we have found that petitioner's misrepresentation related to its right to file a consolidated return, and not to the correct taxable year, petitioner did not prevent respondent from issuing what would otherwise have been a timely deficiency notice. Compare *Stearns Co. v. United States*, 291 U.S. 54, 61-62 (1934).

As it turned out, however, there were no deficiencies because CDS did not have the taxable years indicated in the December 23, 1975, notice of deficiency. 80 T.C. at 531 (*Century Data I*). Nevertheless, respondent cannot now legitimately argue that he was misled by petitioner's affirmative misstatement that he relied on that statement and that it caused him to fail to timely issue a notice of deficiency, none of which comports with the facts at hand.[9]

Respondent's second argument, although somewhat more perplexing, is nonetheless insufficient to support his contention that petitioner should be estopped from asserting the statute of limitations defense. Respondent's position, simply stated, is that petitioner had an affirmative obligation to inform respondent that the statutory notice of deficiency was defective.

In *Atlas Oil II*, the taxpayer took the position that his tax liability should be computed on a calendar year basis in order to obtain the benefits of section 112(b)(10) of the 1939 Code (as in effect for 1943), which was not applicable to

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limitations expiration dates being Mar. 16, 1976, for the calendar year 1971 and the short taxable year ended Apr. 3, 1972, and Dec. 31, 1975, for the calendar year 1970.

[9] In the case of CDS's short taxable year ended Apr. 3, 1972, the defect in the Commissioner's original deficiency notice in *Century Data I* resulted from his failure to correctly determine the exact date of the transaction whereby Cal Comp acquired sufficient additional shares of CDS common stock to give Cal Comp an 80-percent equity interest in the corporation. Respondent concedes that this miscalculation is in no way related to Sword's affirmative misstatement and does not rely on such misstatement to support his estoppel argument for the taxable year ended Apr. 3, 1972. Rather, respondent's sole contention regarding the taxable year ended Apr. 3, 1972, is that CDS should have brought the mistake to respondent's attention.

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taxable years beginning before January 1, 1943. 22 T.C. at 555 (*Atlas Oil II*). Respondent rejected this contention. We found this to be a significant factor in rejecting respondent's estoppel argument. 22 T.C. at 560 (*Atlas Oil II*).

Respondent's efforts to distinguish *Atlas Oil II* from this case fail to recognize that the linchpin of our decision in *Atlas Oil II* was that the predicament respondent found himself in was not created by the taxpayer. 22 T.C. at 560. The fact that petitioner failed to argue that it was a calendar year taxpayer cannot of itself redefine the responsibility imposed by law on respondent. The returns filed by CDS, although erroneous, nevertheless included the periods now in question. As we held in *Atlas Oil II*, "In the absence of any evidence or claim that such return was false or fraudulent with intent to evade tax, it became the duty of the Commissioner to determine, within the time provided by law, whether or not the return was erroneous in any respect." 22 T.C. at 556; *Mabel Elevator Co. v. Commissioner*, 2 B.T.A. 517, 519 (1925).

Respondent does not contend that either CDS or Cal Comp had any actual knowledge of the substantive significance of the defective statutory notice of deficiency prior to expiration of the statute of limitations or that the companies made a conscious decision to permit the statute to expire before they notified the Commissioner of the problem. Rather, respondent argues that each taxpayer is charged with constructive knowledge of its own taxable years and is required as a matter of law to inform respondent if deficiencies are being determined for wrong taxable years.

In support of his position, respondent cites dictum in two cases, neither of which is analogous to the issue before us. Both cases deal with a taxpayer's obligation to abide by his affirmative representations to the Commissioner where the Commissioner has relied on those representations.

In *Lignos v. United States*, 439 F.2d 1365 (2d Cir. 1971), the taxpayers had agreed to a simultaneous administrative settlement of the year 1961, which was docketed in the Tax Court, and the years 1962 and 1963, which were undocketed. Subsequently, the taxpayers sued for a refund for the years 1962 and 1963. The District Court granted

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summary judgment to the Government, holding the taxpayers estopped from claiming the refund because their failure to indicate that they did not consider the settlement of 1962 and 1963 to be final was a "wrongful misleading silence." The Second Circuit reversed and remanded stating:

> Obviously, the taxpayers played their cards close to the vest, although whether excessively so remains to be determined. The key questions are whether there was a false representation or wrongful misleading silence by plaintiffs regarding their intention not to claim a refund for 1962 and 1963, upon which the Government relied to its detriment. [439 F.2d at 1368-1369.]

Thus, unlike here, the crucial question in *Lignos* was whether representations made in entering into a consensual agreement regarding the settlement of litigation was sufficiently contrary to the true intentions of the taxpayers to constitute a wrongful misleading silence.

In *Cary v. Commissioner*, 48 T.C. 754 (1967), the taxpayer had executed a consent form to extend the statute of limitations which was intended to be for the year 1957 but which erroneously listed the extension date, 6/30/62, as the taxable year. Respondent unilaterally corrected the error before executing the form and then relied on its validity. The taxpayer argued that the consent form was invalid and therefore the statute of limitations had expired. Respondent countered by contending that the taxpayer should be estopped from raising the statute of limitations defense.

We rejected respondent's argument because the facts indicated that respondent was well aware of the error in the form. However, we went on to hypothesize a different scenario upon which estoppel might be based:

> Here the facts show that petitioner on the advice of his accountant concurred in by his attorney deliberately sent a document to the Internal Revenue Service which he and his representatives knew contained an error which he and his representatives considered material. Neither petitioner nor his representatives directed the attention of the Internal Revenue Service to the error in the instrument. Had no change been made in the instrument in the Internal Revenue Service, these facts might justify the conclusion that petitioner was estopped to deny that the document he submitted to the Internal Revenue Service was an extension of the statute of limitations on assessment for the year 1957 because of petitioner's misleading the respondent to respondent's detriment. [48 T.C. at 765.]

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Again, respondent has failed to recognize the crucial significance of the hypothetical affirmative misrepresentation as a condition precedent to application of the estoppel doctrine based on a wrongful misleading silence.

Here, we can find no affirmative misrepresentation by petitioner pertaining to the correct taxable years of CDS which would justify categorizing the failure to inform respondent of the defective deficiency notice as a wrongful misleading silence. Rather, the responsibility for the error must rest with respondent's agent, who was charged with the responsibility of determining petitioner's correct tax liability. As long as the necessary books and records are available to the examining agent, he alone is responsible for developing whatever data is necessary for the proper computation of tax liability. See, e.g., *Joyce v. Gentsch*, 141 F.2d 891, 896-897 (6th Cir. 1944); *Helvering v. Schine Chain Theatres*, 121 F.2d 948, 950 (2d Cir. 1941); *Helvering v. Brooklyn City R. Co.*, 72 F.2d 274, 275 (2d Cir. 1934); *Pancoast Hotel Co. v. Commissioner*, 2 T.C. 362, 368 (1943); *Mabel Elevator Co. v. Commissioner*, 2 B.T.A. 517, 519 (1925).

The agent had available to him the books and records of CDS. Moreover, prior to the erroneous inclusion on Cal Comp's consolidated return, CDS had filed on a calendar year basis. Regardless of the reasonableness of the agent's action, the fact remains that he chose not to examine the books and records of CDS before computing the adjustments to CDS's tax liability. This decision was made of his own accord, without any misrepresentations by petitioner, and unfortunately for respondent led to the issuance of a defective notice of deficiency.

Furthermore, the consolidated return defect which the Joint Committee examiner first detected and which the agent himself confirmed through his perusal of the corporate minutes might have alerted a more inquisitive individual to the potentiality of other problems. That the agent did not choose to pursue this trail should not be left at petitioner's door.

We reject respondent's contention that petitioner had an affirmative obligation to correct the erroneous assumption made by the agent that CDS was a fiscal year taxpayer,

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where, as here, petitioner did nothing to encourage the faulty assumption. Accordingly, we hold that petitioner is not equitably estopped from asserting the statute of limitations defense.

Respondent has conceded that the statute of limitations had expired prior to the issuance of the corrected deficiency notice on November 7, 1983.[10] It necessarily follows that the statute of limitations bars the assessment of the deficiencies determined here. As stated in *Atlas II:*

> It may appear to be harsh to the Government to hold that the statute of limitations bars the assessment of the deficiencies here asserted; but the expiration of the period of limitations often works hardships on one party or the other. [22 T.C. at 561.]

Whatever harshness may be present here is mitigated by the knowledge that respondent had the opportunity and the means to issue a timely notice of deficiency for the current taxable years, but failed to do so. The consequences of respondent's agent's actions must be born by respondent and not imputed to petitioner.

To reflect the foregoing,

An appropriate order and decision will be entered.

KENYATTA CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22262-84. Filed February 12, 1986.

Petitioner was organized in 1973 to provide personal services such as radio and television appearances, sportscasting, college campus lectures, newspaper columns, and the like. Respondent determined that petitioner is liable under

[10]Respondent's concession that the statute of limitations had expired prior to the issuance of a corrected deficiency notice precludes a reexamination of our holding in *Atlas Oil & Refining Corp. v. Commissioner*, 22 T.C. 552, 556 (1954) (*Atlas Oil II*), that the statute of limitations begins to run once returns have been filed including the correct periods in issue, irrespective of the erroneous nature of the returns filed. In light of the Court's recent line of cases delineating what constitutes a return, respondent's previously rejected "no return" argument might well deserve another look. However, any reexamination of this Court's *Atlas Oil II* holding would only be appropriate after the Court has been afforded the benefit of comprehensive briefs addressing the issue.

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sec. 541, I.R.C. 1954, for personal holding company tax for its fiscal year ended Jan. 31, 1978. *Held*, the burden of proof rests with petitioner regardless of whether the Commissioner's agents examined all of petitioner's personal service contracts before the notice of deficiency was issued. *Held, further*, the stock ownership test prescribed by sec. 542(a)(2), I.R.C. 1954, is met even though petitioner never issued stock certificates. *Held, further*: More than 60 percent of petitioner's adjusted ordinary gross income was derived from personal service contracts within the meaning of sec. 543(a)(7), I.R.C. 1954. Accordingly, for its fiscal year ended Jan. 31, 1978, petitioner was a personal holding company, within the meaning of sec. 542(a), I.R.C. 1954, and subject to the personal holding company tax.

Arthur H. Boelter, for the petitioner.
Robert F. Geraghty, for the respondent.

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $24,943 in petitioner's personal holding company tax for its fiscal year ended January 31, 1978. The only issue to be decided is whether, during that year, petitioner was a personal holding company within the meaning of section 542(a).[1]

FINDINGS OF FACT

Petitioner Kenyatta Corp. was a Washington State corporation with its principal office located in Seattle, Washington, at the time the petition was filed. Petitioner timely filed its corporate Federal income tax return for its fiscal year 1978 with the Internal Revenue Service Center, Ogden, Utah.

Background

Petitioner was incorporated under the laws of the State of Washington on July 9, 1973. However, no organizational meeting was held for petitioner, and no stock certificates were ever issued. Each year from its inception through the close of its 1978 fiscal year, petitioner's president was William F. Russell (hereinafter Russell).

[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted. All Rule references are to the Tax Court Rules of Practice and Procedure.

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Russell, a former professional basketball player, has long been a well known and highly regarded sports personality. Since 1969, following his retirement from professional basketball, Russell has been employed, first by Felton Productions and later by petitioner, to provide a variety of his own personal services. These services included hosting radio talk shows, making personal appearances, lecturing on college campuses, sportscasting, writing newspaper columns, coaching and managing a professional basketball team, speaking on radio and television programs, and performing services for various advertising and promotional efforts.

In 1969, Robert Walsh (hereinafter Walsh), then program director for KABC radio station in Los Angeles, hired Russell as a radio talk show host and television sportscaster. In 1973, Russell moved to Seattle to become the coach and general manager of the Seattle SuperSonics professional basketball team (hereinafter Sonics).

Russell was joined in Seattle by Walsh, who became assistant general manager of the Sonics under Russell, and by Anita Dias (hereinafter Dias), who had been employed in Los Angeles by Felton Productions, the California corporation which provided Russell's personal services from approximately 1970 to 1973. From 1973 to 1977, Dias worked for the Sonics and provided services to petitioner as administrative assistant and secretary to Russell, handling his calendar, travel arrangements, and banking. She signed most of the documents requiring Russell's signature. Dias ran the day-to-day operations of petitioner's office, kept books for some transactions, and maintained a checking account for petitioner in Seattle.

Petitioner was organized on the advice of Richard Covey (hereinafter Covey), who served as petitioner's secretary from its inception through at least September 6, 1978. In his capacity as secretary, Covey maintained a bank account for petitioner in Los Angeles and kept most of petitioner's books and records with him in Los Angeles during petitioner's 1978 fiscal year. Covey was also Russell's attorney and business agent from 1969 until 1982. During that period, he assisted in developing Russell's career and generating business opportunities and handled legal mat-

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ters, such as negotiating and drafting contracts. Covey generally received fees for his legal services and compensation on a percentage basis for his services as Russell's agent.

In addition to providing Russell's services for speaking engagements, personal appearances, and the like, petitioner arranged for the services of other sports personalities. Petitioner was asked to provide substitutes when Russell was unavailable or not inclined to make certain types of personal appearances; for example, Russell made it a policy never to sign autographs.

Fiscal Year 1978

Ken Duncan (hereinafter Duncan), a certified public accountant, was hired in 1977 to prepare both petitioner's corporate Federal income tax return for its 1978 fiscal year and Russell's individual tax return. In preparing petitioner's 1978 return, Duncan used two lists of checks drawn from and deposits made into petitioner's checking accounts--one handwritten list prepared by Dias and one typewritten list prepared by Covey (bank deposits and disbursements list).[2] Duncan never received a cash receipts journal, check register, or canceled checks for fiscal year 1978.

At the request of the revenue agent who examined petitioner's fiscal year 1978 income tax return, Duncan prepared a handwritten breakdown of petitioner's cash receipts from its 1978 fiscal year (cash receipts breakdown). The document is dated June 4, 1983, and bears the notation: "Big Rush—Vacation starts this afternoon for 1 week out of town." Duncan prepared the cash receipts breakdown using "scraps of paper" and whatever information was available at the time.

On its corporate income tax return for fiscal year 1978, which was signed by Russell as president, petitioner reported gross receipts in the amount of $138,895 and taxable income in the amount of $44,919. Petitioner reported no reduction for cost of goods sold, and no deductions for

[2]The list of bank deposits and disbursements submitted by Covey and used by Duncan covers only the period from Sept. 22, 1977, to Jan. 31, 1978. The list prepared by Dias was not submitted as evidence in this case.

commissions, salaries, and wages paid.[3] On page 3 of the return, item H(2) names Russell as the individual who owned, at the end of the taxable year, 50 percent or more of petitioner's voting stock, and an attached schedule shows that he owned 100 percent of the stock in that year.[4]

Petitioner's gross receipts from its 1978 fiscal year were derived from various sources, among which were several service contracts here in dispute. The following are our findings with respect to each of those agreements.

1. *Seattle SuperSonics*

In 1973, the professional basketball franchise known as the Seattle SuperSonics was owned by the Seattle SuperSonics Corp., a wholly owned subsidiary of First Northwest Industries of America, Inc. (FNI). During that year, the Sonics' image and popularity had declined as a result of poor public relations and unfavorable press coverage. The board of directors of FNI discharged the Sonics' coach and made an effort to replace him with the best name in basketball to restore the team's credibility. Consequently, Russell was hired as coach and general manager of the Sonics in July 1973.

The contract negotiations eventually produced two contracts, one between FNI and Russell covering Russell's services as coach and general manager of the Sonics (coaching agreement) and the other between FNI and petitioner covering publicity and public relations services to be provided by petitioner (public relations agreement). Both contracts were signed by or on behalf of the parties,[5] dated "As of July 1, 1973," and ran for a term of 5 years commencing on that date and terminating on June 30, 1978.[6]

[3]Petitioner deducted $4,700 for "research & writing fees," and $24,332 for "legal & acctg."

[4]Petitioner's corporate income tax returns for its fiscal years 1977 through 1983 indicate that Russell held either 100 percent or 70 percent of its voting stock as of the close of each year.

[5]The coaching agreement bore a signature line for Samuel Schulman, controlling shareholder and chief executive of FNI, in his capacity as an individual, but the signature line was left blank. Two letters dated Oct. 12, 1973, one from Samuel Schulman to Russell and one from Russell to FNI, covered the obligation of Samuel Schulman individually under the coaching agreement.

[6]The coaching agreement and the public relations agreement were terminated as of June 30, 1977, and July 1, 1977, respectively, pursuant to a letter from FNI to Covey releasing FNI and petitioner from their obligations under the public relations agreement.

Under the public relations agreement, petitioner agreed to provide Russell's services in connection with certain public relations work for the Sonics, including a series of 5-minute radio programs to be broadcast prior to the Sonics' games. As consideration for services to be rendered under the public relations agreement, petitioner agreed to accept $250,000 payable in 60 equal monthly installments commencing July 1, 1973. The public relations agreement provides by its terms in pertinent part:

A. William F. Russell (Russell) has executed a personal services agreement with Kenyatta whereby Russell has granted to Kenyatta all rights to his services, name, image, voice and likeness, with the exception of the basketball coaching and general managing services described in an Employment Agreement executed between Russell and FNI for the coaching and general managing services of Russell, dated "As of July 1, 1973."

B. Russell is a prominent personality with a national reputation as a commentator, entertainer, professional athlete and spokesman; and whose name, likeness and image is of established commercial value.

C. FNI is desirous of utilizing the name, image and likeness of Russell in, and in connection with, the exploitation and advertising of its basketball team, the Seattle SuperSonics (Sonics).

* * * * * * *

1. *Grant of Rights.*

Kenyatta hereby grants to FNI, during the term hereof, the following rights:

a. The right, subject to the provision of Paragraph 4, to use Russell's name, image voice and likeness by means of television, radio and publications to advertise and exploit the Seattle SuperSonics and its activities.

b. The right to use Russell's services, live or recorded, for a series of five (5) minute radio programs, each episode to be broadcast one time prior to a basketball game played by the Seattle SuperSonics; said services to be contracted and paid for by Radio Station KOMO (or any other radio stations which Sonics contract to carry the broadcast of the games).

As reflected by respondent's Form 1099-Misc. issued by the Seattle SuperSonics Corp. to petitioner and the audit workpapers prepared by the Seattle SuperSonics Corp.'s accountant, petitioner received income in the amount of $20,833.30 during its 1978 fiscal year pursuant to the public relations agreement.

2. *KIRO-TV*

In 1977, KIRO television (KIRO-TV), the CBS affiliate in Seattle, employed Russell, then coach of the Sonics, to perform in a 5-minute pre-game coach's show prior to each of the 15 Sonics games televised on KIRO-TV. Payments for Russell's services were made by checks dated March 15, 1977 and April 12, 1977, payable to Russell in the amounts of $3,750 and $1,875, respectively. Duncan included these payments on his cash receipts breakdown. The payments were not reported on Russell's 1977 individual income tax return.

3. *ABC Sports*

Pursuant to a contract dated "As of September 1, 1977," petitioner agreed to furnish to ABC Sports, Inc. (ABC Sports), the "exclusive personal services of Mr. Russell, * * * [petitioner's] employee, as commentator, host, co-host, expert analyst, interviewer and the like in connection with television sports and news programs * * * for broadcast by ABC." The term of the contract was 3 years commencing September 1, 1977. The parties agree that ABC Sports made the following payments to petitioner pursuant to their agreement during petitioner's 1978 fiscal year:

	Check date	*Amount*
Salary	9/26/77	$10,416.66
	10/17/77	10,416.66
	11/16/77	10,416.66
	12/14/77	10,416.66
	1/23/78	10,416.66
Expense reimbursement	1/23/78	[1]1,061.75
Total		53,145.05

[1]Both the expense reimbursement and the January salary payment were included on the same check dated 1/23/78.

Covey included these payments from ABC Sports on his bank deposits and disbursements list.[7]

[7]Covey's bank deposits and disbursements list includes an additional payment of $2,056.11 from ABC Sports deposited in petitioner's account on Jan. 4, 1978. Duncan's cash receipts breakdown shows cash receipts from ABC Sports totaling $54,395.04.

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4. *Seattle Times*

Pursuant to a contract dated "As of September 1, 1977," petitioner agreed to furnish "the services of William F. Russell ('Russell') to provide material for a weekly newspaper column ('the column') which will appear exclusively in The Seattle Times." In consideration of Russell's services, petitioner contracted to receive $250 per column to be paid weekly during the contract term commencing on September 15, 1977, and terminating one year later. The agreement contains the following additional provision:

> Russell and * * * [petitioner] acknowledge there is a valid and existing personal services agreement between Russell and Kenyatta Corporation, and Russell agrees to perform all terms and conditions contained in this agreement.

The agreement further provides that petitioner retain the copyright to each column.

Russell was assisted in writing the Seattle Times columns by Taylor Branch and Walt Crowley, both professional writers, Russell's then wife, Didi Anstett Russell (hereinafter Didi Anstett), and Dias. In some instances, the articles were written by Taylor Branch or Didi Anstett from tapes or notes of a group discussion with Russell on the weekly topic. These articles were then subject to Russell's approval. A list of the articles compiled by Didi Anstett from a scrapbook she kept revealed that 20 articles were published during petitioner's 1978 fiscal year; the first article was published on September 18, 1977, and the last on January 29, 1978. As reflected in the requests for checks issued to the accounts payable department of the Seattle Times, petitioner received at least 19 payments of $250 each for a total of $4,750 during its 1978 fiscal year in consideration for the columns.[8]

5. *Cole & Weber*

In 1977, petitioner received $15,000 from Cole & Weber, an advertising and public relations firm located in Seattle. The payment represented a talent fee for Russell's services

[8]Covey's bank deposits and disbursements list includes an additional payment of $2,056.11 from ABC Sports deposited in petitioner's account on Jan. 4, 1978. Duncan's cash receipts breakdown shows cash receipts from ABC Sports totaling $54,395.04.

in connection with a series of television commercials for a local dairy company. The commercials featured Russell and Jack Patera, then coach of the Seattle Seahawks professional football team, and depicted Russell as Patera's "shape up" coach encouraging him to become physically fit through a combination of exercise and a diet of various dairy products. Covey included the payment from Cole & Weber on his bank deposits and disbursements list.

Using the taxable income figure in petitioner's income tax return for fiscal year 1978, respondent determined the deficiency in personal holding company income tax described above.

OPINION

The only issue to be decided is whether petitioner was a personal holding company within the meaning of section 542(a) during 1978 and is, therefore, subject to the personal holding company tax.[9] A corporation is a personal holding company if it meets a stock ownership test and a "tainted 0ncome" test which are specified in section 542(a).[10] Before analyzing the evidence in the light of these tests, however, we must dispose of a preliminary argument on which petitioner pins much of its case.

Petitioner contends that respondent has the burden of proving that petitioner was a personal holding company during its fiscal year 1978 because the Commissioner's agents, before issuing the notice of deficiency, did not possess or examine all of the contracts from which petitioner received its income. Petitioner admits that it did not have, or present to the agents, the contracts (excepting the

[9]SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

[10]SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) GENERAL RULE.—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) ADJUSTED ORDINARY GROSS INCOME REQUIREMENT.—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) STOCK OWNERSHIP REQUIREMENT.—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. • • •

ABC Sports contract) or other records which reflected the nature and source of its income. Because the agents did not obtain the contracts from third party sources by summons or otherwise, the argument goes, the notice of deficiency does not have a proper foundation of substantive evidence, is arbitrary, and is not entitled to the so-called presumption of correctness under the rationale of *Weimerskirch v. Commissioner*, 596 F.2d 358, 361 (9th Cir. 1979), revg. 67 T.C. 672 (1977), and *Llorente v. Commissioner*, 649 F.2d 152 (2d Cir. 1981), affg. in part and revg. and remanding in part 74 T.C. 260 (1980).

There is no merit in petitioner's argument. A trial in this Court with respect to a deficiency determination is a de novo proceeding; it does not involve a review of the evidence in the hands of the Internal Revenue Service when the notice of deficiency was issued. Only in limited circumstances, not present here, will the Court go behind the notice of deficiency. *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327-328 (1974); see *Crowther v. Commissioner*, 269 F.2d 292, 293 (9th Cir. 1959), affg. on this issue 28 T.C. 1293 (1957). Petitioner's status under the personal holding company tax provisions thus does not turn on what evidence the Internal Revenue Service agents had in their files when the notice was issued but on the evidence presented in this Court.

The *Weimerskirch-Llorente* line of cases has nothing to do with the issue here presented. In those cases, the Commissioner determined that the taxpayers had substantial income from the illegal sale of narcotics. The Commissioner offered no evidence showing that the taxpayers received income from such source or otherwise linking the taxpayers to illegal narcotics dealing from which income was derived, and the taxpayers offered no credible evidence rebutting the charge that they did so. In these circumstances, the appellate courts held that the so-called presumption of correctness, usually applied to support a deficiency determination, did not attach and would not sustain the determined deficiencies.[11] Furthermore, those cases were decided on the

[11] The rule laid down by the Courts of Appeals in those cases may be analogized to the "likely source" requirement for use of the net worth increase and nondeductible expenditures method of income reconstruction as explained in *Holland v. United States*, 348 U.S. 121 (1954).

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trial record, not on what was contained in the Internal Revenue Service files when the notice of deficiency was issued.[12] Respondent in the instant case does not rely upon any presumption of correctness but at the trial offered much of the evidence reflected in our findings of fact. Moreover, the deficiency in the instant case is based on the figures in petitioner's own income tax return; no form of income reconstruction is involved. The only issue is the character of the income—whether it was personal holding company income. We hold that the burden of proof rests with petitioner. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

Stock Ownership Test

The stock ownership test prescribed by section 542(a)(2) is satisfied if, at any time during the last half of the taxable year, more than 50 percent in value of the corporation's outstanding stock is owned, directly or indirectly, by or for not more than five individuals. Petitioner argues that because no stock certificates were issued, the corporation does not meet the requirements of the stock ownership test. However, the issuance of stock certificates is not determinative of stock ownership for purposes of section 542(a)(2). Sec. 1.542-3(b), Income Tax Regs.; *Collateral Equities Trust v. Commissioner*, 39 B.T.A. 834, 839-840 (1939). Furthermore, Covey, the attorney responsible for organizing petitioner, testified that Russell was intended to be the majority stockholder in the corporation and that the major-

[12]The *Weimerskirch-Llorente* line of cases (*Weimerskirch v. Commissioner*, 596 F.2d 358 (9th Cir. 1979), revg. 67 T.C. 672 (1977); *Llorente v. Commissioner*, 649 F.2d 152 (2d Cir. 1981), affg. in part and revg. and remanding in part 74 T.C. 260 (1980)) does not, in any event, alter the rule on the burden of proof. The court in *Weimerskirch v. Commissioner*, 596 F.2d at 360 n. 3, expressly stated that it did not "reach the question as to who has the general burden of persuasion in this type of case." In *Carson v. United States*, 560 F.2d 693, 698 (5th Cir. 1977), cited and quoted in *Weimerskirch*, the Court of Appeals found that the evidence did not show that the taxpayer had engaged in gambling activities during part of the period for which a wagering excise tax had been assessed and that, therefore, the assessment for that part of the period could not stand, stating:

"We work no change in the burden or order of proof in wagering excise tax cases. We simply recognize that, at the close of all the evidence, if the record contains no item of proof tending to show that the taxpayer was engaged in wagering activity during the period assessed, the Commissioner's determination cannot prevail. The record before us contains no such predicate. * * *"

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ity of the equity in petitioner belonged to Russell in "some unfocused way."

More important, petitioner's articles of incorporation show that it had only one class of stock, and its 1978 tax return designated Russell as holder of 100 percent of petitioner's voting stock.[13] This sworn statement of voting stock ownership is an admission to which we give substantial weight. *Waring v. Commissioner*, 412 F.2d 800, 801 (3d Cir. 1969), affg. per curiam a Memorandum Opinion of this Court; *Times Tribune Co. v. Commissioner*, 20 T.C. 449, 452 (1953). Finally, nothing in the record establishes that anyone other than Russell owned any of petitioner's outstanding stock at any time during its 1978 fiscal year.

In light of petitioner's admission under oath and its failure to carry its burden of proving that someone other than Russell owned the majority of petitioner's outstanding stock, we find that at least 50 percent of the value of petitioner's outstanding stock was owned by not more than five individuals within the meaning of section 542(a)(2).

Tainted Income Test

The tainted income test provided by section 542(a)(1) is met if at least 60 percent of the corporation's "adjusted ordinary gross income" for the taxable year constitutes "personal holding company income."[14] Section 543(a), which defines personal holding company income, provides in pertinent part:

> SEC. 543(a). GENERAL RULE.—For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:
>
> * * * * * * *
>
> (7) PERSONAL SERVICE CONTRACTS.—
>
> (A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who

[13] See note 4 *supra*.

[14] "Adjusted ordinary gross income" is defined in sec. 543(b) as gross income less gains from the sale or other disposition of capital assets or sec. 1231(b) assets, and less depreciation, taxes, interest, and rent incurred in connection with certain rental income and mineral royalties. In the instant case, petitioner's adjusted ordinary gross income would equal its gross income.

is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.[15]

Petitioner contends, first, that petitioner's income did not arise from personal service contracts within the meaning of section 543(a)(7), and, alternatively, to the extent petitioner had income from personal service contracts which would constitute personal holding company income, such income did not equal 60 percent or more of its adjusted ordinary gross income.

Determination of whether a contract is a personal service contract again requires examination of the contract under two statutory tests. The flush language of section 543(a)(7) requires that the designated person (herein Russell) own at least 25 percent of the corporation's stock at some time during the taxable year (stock ownership test). We have found as a fact that Russell owned at least 50 percent in value of petitioner's stock; therefore, this test is met.

The stock ownership test having been met, we turn now to the language of section 543(a)(7)(A), which requires that the individual who is to perform the services be designated, by name or description, in the contract or that such individual can be so designated by some person other than the corporation (designation test). We will examine each contract separately to determine whether it meets this requirement.

1. *Seattle SuperSonics*

During 1977, Russell was employed by FNI, then owner of the Sonics, as coach and general manager of the profes-

[15] This provision on personal service contracts was enacted to close the so-called "'incorporated talent' loophole" whereby individuals receiving large amounts of personal service income could avoid the effect of the progressive income tax rates by arranging for wholly owned corporations to contract for, and receive compensation for, their services. S. Rept. 1242, 75th Cong., 1st Sess. (1937), 1937-2 C.B. 609, 613; *Kurt Frings Agency, Inc. v. Commissioner*, 42 T.C. 472, 477 (1964), affd. per curiam 351 F.2d 951 (9th Cir. 1965).

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sional basketball team. Russell's employment was covered under two separate contracts, a coaching agreement between FNI and Russell, himself, and a public relations agreement between FNI and petitioner. The public relations agreement obligated petitioner to provide Russell's services in connection with certain public relations activities for the Sonics, including a series of pre-game radio programs. The public relations agreement, quoted in part in our findings, designates Russell by name as the individual who was to perform the services and states its purpose in naming Russell. Because the public relations agreement designates Russell by name as the individual to perform the services, the contract meets the designation test under section 543(a)(7). *General Management Corp. v. Commissioner*, 46 B.T.A. 738, 747 (1942), affd. 135 F.2d 882 (7th Cir. 1943); *Kurt Frings Agency, Inc. v. Commissioner*, 42 T.C. 472, 478-479 (1964), affd. per curiam 351 F.2d 951 (9th Cir. 1965).

Petitioner's argument with respect to the public relations agreement is based entirely on attacking the validity of the document, itself.[16] Petitioner does not contend that the document, which was signed by or on behalf of both parties, is completely false but that the document upon which our findings are based is an interim draft which does not represent the "final agreement" of the parties.

Petitioner contends that Russell was not designated by name or description in the final agreement between the parties because other sports personalities were substituted for Russell when he was unavailable for or unwilling to make certain personal appearances. While we have found as a fact that petitioner made such substitutions, that fact does not prove petitioner's point. First, it is not clear from the record that the substitutions for Russell were made with respect to appearances covered by petitioner's agreement with FNI. The testimony of both Russell and Dias indicates that petitioner was in the business of providing

[16] Petitioner has objected strenuously to the admission of the public relations agreement. Apparently, the original contract could not be located. We have admitted a duplicate copy of the agreement under rules 803(6) and 1004 of the Federal Rules of Evidence. The controller of the Sonics testified that she had custody of the public relations agreement, that the agreement was maintained in the ordinary course of the Sonics' business, and that the agreement was used by her in preparing the Sonics' payroll and other checks.

talent for speaking engagements and public appearances, which may or may not have been associated with the Sonics or FNI. Second, the public relations agreement, as we read it, does not preclude such substitutions.[17]

Finally, if the public relations agreement admitted in evidence is not the final agreement between the parties, as petitioner contends, petitioner has not met its burden of proving that the final agreement between petitioner and FNI by its terms did not designate Russell as the individual who was to perform the services. Rule 142(a).

2. *KIRO-TV*

The issue with respect to Russell's employment with KIRO-TV is not whether the contract designated Russell by name or description, but whether the contract for Russell's services was between KIRO-TV and Russell or between KIRO-TV and petitioner. If the agreement was made with Russell personally, the income therefrom would be properly taxable to Russell and would not qualify as petitioner's personal holding company income. Sec. 543(a), (b). We think the weight of evidence shows that the contract for Russell's services was between KIRO-TV and Russell personally.

First, we note that the contract governing Russell's employment with KIRO-TV was not produced at trial. However, the program director for KIRO-TV at that time testified that the contract was with Russell personally, that he had no knowledge of petitioner at the time his station contracted with Russell, and that he was never asked to pay petitioner in connection with Russell's services. Rather, payments for Russell's services were by checks made payable to him personally.[18] Based on the foregoing, we find that the agreement with KIRO-TV for Russell's services was made with him personally; and, therefore, the payments

[17] Petitioner also offered testimony to the effect that the final agreement between petitioner and FNI would have provided for the employment of Walsh and Dias by the Sonics. However, other testimony showed that Walsh and Dias were paid directly by the Sonics and that Walsh was employed by the Sonics under a separate written contract. Furthermore, we do not think the terms of their employment would have been appropriate matter for inclusion in the public relations agreement.

[18] The payments from KIRO-TV appear on Duncan's cash receipts breakdown as petitioner's cash receipts; however, we give less weight to this evidence primarily because Duncan prepared the schedule in a "big rush" from unspecified sources of information several years after the fact.

from KIRO-TV do not constitute personal holding company income to petitioner.

3. *ABC Sports*

In 1977, petitioner contracted with ABC Sports to provide Russell's services as commentator, host, co-host, expert analyst, interviewer, and the like in connection with television sports and news programs. During its 1978 fiscal year, petitioner received payments totaling $53,145.05 pursuant to its agreement with ABC Sports. Petitioner admits that the contract with ABC Sports specifically designated Russell as the person who was to perform the services and that the income from their agreement is "tainted income."[19]

4. *Seattle Times*

In September 1977, petitioner agreed to furnish Russell's services in providing material for a weekly column to appear in the Seattle Times. With respect to petitioner's agreement with the Seattle Times, petitioner relies on section 1.543-1(b)(8)(ii), Income Tax Regs.,[20] in arguing that the services of other individuals were "important and essential" to the contract; and, therefore, the amounts attributable to their services should not be included in personal holding company income. We disagree.

The regulation was interpreted by this Court in *Kurt Frings Agency, Inc. v. Commissioner*, 42 T.C. 472 (1964), affd. per curiam 351 F.2d 951 (9th Cir. 1965). The taxpayer in that case was a corporation engaged in the business of representing various clients in the entertainment field as their manager. Each contract executed between the tax-

[19]Petitioner has not met its burden of proving that an amount designated by ABC Sports as expense reimbursement ($1,061.75) should be excluded from the personal holding company income computation as income of a "nonpersonal holding company type." *General Management Corp. v. Commissioner*, 46 B.T.A. 738, 749 (1942), affd. 135 F.2d 882 (7th Cir. 1943).

[20]Sec. 1.543-1(b)(8)(ii), Income Tax Regs., provides:

"If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated * * * [within the meaning of section 543(a)(7)], requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. * * *"

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payer and the various artists designated "Kurt Frings," the sole stockholder, as the individual required to personally supervise the artists' business. The taxpayer also employed a number of subagents who represented and negotiated contracts for some of the artists under contract. The taxpayer argued that the services performed by its subagents were "important and essential" within the meaning of section 1.543-1(b)(8)(ii), Income Tax Regs., and, therefore, an allocation must be made to determine the income attributable to the services performed by Kurt Frings. The taxpayer relied on the following language from the regulation:

> The contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated * * * requires the performance of services by other persons which are important and essential * * *

This Court found that the controlling word in the regulation is "requires" and that the word must be given its ordinary and common meaning. Because the contracts designated Kurt Frings and required no other persons to perform the services, the Court held that the contract was a personal service contract within the meaning of section 543(a)(7).

Nowhere in the Seattle Times contract are the services of anyone other than Russell required; rather, the agreement specifies that Russell will perform all terms and conditions under the contract. In addition, petitioner produced no evidence to indicate that the Seattle Times knew of or even contemplated the use of "ghost writers" for the columns. Based on the record in the instant case and in keeping with our earlier interpretation of the regulation, we find that the Seattle Times contract did not require the services of others which were important and essential.[21]

5. *Cole & Weber*

In 1977, petitioner received $15,000 from Cole & Weber, an advertising and public relations firm, as a talent fee for

[21] We recognize that several individuals, including two professional writers, assisted Russell in providing material for the Seattle Times columns. At least some of the 20 articles were written by Taylor Branch or Didi Anstett from tapes or notes of discussions with Russell. Petitioner contends that because Russell did not actually write these columns, but contributed only his ideas and his name, the services of those who assisted him were important and essential. However, the Seattle Times contract did not require the services of those individuals who assisted Russell and to interpret "require" to mean "may require" would be contrary to the regulation. *Kurt Frings Agency, Inc. v. Commissioner*, 42 T. C. at 480.

Russell's services in connection with a series of television commercials for a local dairy company. The commercials featured Russell and Jack Patera, then coach of the Seattle Seahawks, and depicted Russell as Patera's "shape up" coach encouraging him to become physically fit through exercise and dieting. No contract between Cole & Weber and petitioner for Russell's talent was produced at trial. Payment for Russell's services was made by check payable to petitioner, and Covey included the payment in his bank deposits and disbursements list referred to in our findings. Cole & Weber billed the dairy company for "Talent—Bill Russell" in the amount of $15,000.

Petitioner's primary contention is that Russell's talent was not unique and petitioner could have substituted the services of other individuals to appear in the commercials.[22] However, we think the evidence clearly demonstrates that Russell's talents were unique and substitution would not have been possible. The entire campaign involved Russell, who only months before coached the Sonics, "coaching" Patera, then coach of the Seahawks, to lose weight. The advertisement would not have been as clever or as amusing had someone other than Russell acted as Patera's "shape up" coach. Newspaper advertisements promoting the television commercials featured pictures of both coaches, one stating: 'It takes all Bill Russell's skill to get Jack Patera to stick to his diet and exercise,' and a Seattle Times column concerning the campaign was entitled "Getting in Shape with Two Coaches."

In any event, petitioner has not sustained its burden of proof on this issue. Because Russell performed the services for Cole & Weber, petitioner must show that Russell was not designated, by name or description, in the contract and that petitioner had the right to designate, by name or description, the person to perform the services. Sec. 543(a)(7)(A); Rule 142(a). Petitioner failed to produce the agreement governing the advertising campaign or to present evidence to support its position.

[22] See Rev. Rul. 75-67, 1975-1 C.B. 169; Rev. Rul. 75-249, 1975-1 C.B. 171.

Personal Holding Company Income Computation

Pursuant to our foregoing analysis of the five agreements under which petitioner received income during its 1978 fiscal year, we have found that the following amounts were derived from personal service contracts and, therefore, constitute personal holding company income to petitioner:[23]

Contract	*Personal holding company income*
Seattle Supersonics	$20,833.30
ABC Sports	53,145.05
Seattle Times	4,750.00
Cole & Weber	15,000.00
Total	[1]93,728.35

[1]Amounts received under Russell's agreement with KIRO-TV are not personal holding company income to petitioner.

A corporation is not a personal holding company, within the meaning of section 542(a), unless at least 60 percent of its adjusted ordinary gross income for the taxable year is personal holding income. According to its tax return, petitioner's adjusted ordinary gross income for its 1978 fiscal year is $138,895.[24] Because petitioner's personal holding company income of $93,728.35 exceeds 60 percent ($83,337) of petitioner's adjusted ordinary gross income, petitioner is a personal holding company subject to the personal holding company tax imposed by section 541.

To reflect the foregoing,

Decision will be entered for the respondent.

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[23]Petitioner argues that, assuming the agreements were personal service contracts, the amounts derived therefrom should be reduced by commissions paid to Covey, a nonshareholder, or by cost of goods sold. We reject this argument for three reasons. First, petitioner's 1978 corporate income tax return indicates no allowance for commissions or cost of goods sold. Second, petitioner was unable to establish the amounts of the commissions paid to Covey. Finally, the record is not clear as to whether amounts included on Covey's bank deposits and disbursements list, which was used to determine petitioner's gross income, included Covey's commissions or were net of such amounts.

[24]Respondent urges us to reduce petitioner's adjusted ordinary gross income figure by $5,625 for purposes of our computation. Respondent contends that if we find the amounts received from KIRO-TV to be income to Russell personally, and not personal holding company income to petitioner, the same amount should be excluded from petitioner's gross income in making our calculations. We need not decide this issue, as petitioner's personal holding company income exceeds 60 percent of its adjusted ordinary gross income under both computations.

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JAMES MOSBY AND VIRGINIA MOSBY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JACK S. FOSTER AND PATRICIA FOSTER, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 24519-83, 24534-83. Filed February 14, 1986.

Petitioners incurred legal fees in connection with an inverse condemnation suit against the United States arising out of a dispute over mineral rights reserved in a deed. *Held*, the origin of the claim test, not the primary purpose test, is applied. *Held, further*, such expenditures are capital in nature and, therefore, are not currently deductible.

Charles W. Willey, for the petitioners.
Elaine T. Fuller, for the respondent.

OPINION

COHEN, *Judge*: Respondent determined the following deficiencies in petitioners' income taxes:

Name	*Docket No.*	*Year*	*Deficiencies*
Mosby	24519-83	1977	$13,104
		1978	1,240
		1979	4,774
Foster	24534-83	1978	6,033
		1979	417

The sole issue for decision is whether petitioners may deduct legal fees incurred in connection with an inverse condemnation suit arising out of a dispute over mineral rights reserved in a deed to the United States. Petitioners contend that the legal fees are deductible because the primary purpose of the litigation was to enable them to conduct a quarry business. Further, petitioners contend that if the primary purpose test is inapplicable, the litigation expenses are nevertheless deductible because the origin of the claim was not in the acquisition or disposition of petitioners' mineral interest. Respondent contends that the primary purpose test does not apply and that the legal fees must be capitalized because the origin of the claim was in the disposition of petitioners' mineral interest.

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All of the facts have been stipulated. The stipulated facts and attached exhibits are incorporated by this reference and summarized below. With regard to docket No. 24534-83, the parties also submitted a stipulation of settled issues.

Petitioners James Mosby (Mosby) and Virginia Mosby (collectively, the Mosbys), husband and wife, resided in Lompoc, California, at the time their petition was filed. They filed joint Federal income tax returns in 1977, 1978, and 1979. Petitioners Jack Foster (Foster) and Patricia Foster (collectively, the Fosters), husband and wife, resided in Paso Robles, California, at the time their petition was filed. They filed joint Federal income tax returns in 1978 and 1979.

On June 11, 1942, the United States exercised an option to purchase for $22,750 the surface estate of a certain tract of land referred to as Tract 83. The land was acquired as part of the activation of Camp Cooke, now Vandenberg Air Force Base (Vandenberg), as an Army facility to train armored and infantry divisions.

In the transaction, the seller, the McClellans,[1] reserved the right to all minerals in Tract 83. That reservation is expressed in the deed to the United States, dated June 11, 1942, as follows:

> EXCEPTING AND RESERVING to grantors, their successors and assigns, the following:
>
> All oil, gas, asphaltum and other hydrocarbon substances and other minerals, including diatomaceous earth, in and under the land hereby conveyed, together with all easements, roads and privileges reasonably necessary to explore said land for, and to produce and transport therefrom, any of said minerals; provided, however, that the rights granted by virtue of this reservation shall not be exercised by grantors for period of not less than five (5) years from the date hereon or during the present national emergency, whichever period is longer.

The McClellans were aware that Tract 83 contained sedimentary and ocean-borne rock deposits with potentially substantial commercial value as quarries but had made no attempt to ascertain the composition or nature of the particular deposits.

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[1] Charlotte Mildred McClellan was the beneficial owner of the fee simple interest. The Bank of America National Trust & Saving Association held legal title and was named grantor on the deeds to the United States. Mrs. McClellan's husband generally managed and exercised responsibility over Tract 83.

In 1969, due to several requests by private contractors and State officials to enter Tract 83 and extract various minerals, Headquarters at Vandenberg sought advice from the Chief of the Real Estate Division, Los Angeles District, United States Corps of Engineers, concerning its right to refuse entry to those interested parties. Vandenberg was advised, among other things, that sand and gravel were not minerals and that the McClellans had no right to quarry stone or to authorize others to quarry stone on Tract 83 as that right was exclusive to the Government.

Mosby, as a teenager, had experience in working on mineral claims that involved hard-rock mining and quarry operations. As an undergraduate at Oregon State College, he took all the geology courses available to undergraduates, including mineral identification. In June 1968, Mosby acquired a lease of a rock quarry within 10 miles of Tract 83; he operated that quarry for approximately 3 years. Mosby had also operated a dental practice, developed a parcel of farm land (rice crop), and developed or was in the process of developing a restaurant, a small commercial store, and a medical/dental center in Lompoc.

Foster was a general engineering contractor with extensive experience in rock quarry operations. He had operated his own construction company since 1957. His background included quarrying operations in the Philippines, in Alaska, and on the central coast area of California. Since 1958, his contracting activities have involved building roads, reservoirs, quarry work, building sites, and subdivisions. He owned a 400-space trailer park and a condominium complex and developed, in a joint project, a 22-house subdivision. As of 1981, he owned a ranch containing a redrock quarry.

Foster and Mosby met in 1969, at which time Foster's activities involved mining operations in the See Canyon, Missile City, Morrow Rock, and Cambria Pines quarries. Approximately 2 years later, they entered into an oral joint venture agreement to acquire a mineral interest in Tract 83. On July 8, 1971, petitioners executed a lease with the McClellans wherein petitioners acquired the right to extract certain minerals from Tract 83, i.e.,

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> Lessee shall have the right to extract and remove and take from the premises all riprap rock and this lease does not include sand, gravel, diatomaceous material or petroleum products.

At the time of execution of the lease, neither petitioners nor the McClellans knew of any denial of access to the property or of any dispute as to the right to quarry and remove the rock.

There is a market for riprap in the geographical area of Tract 83; such market is limited by the distance over which stone can be hauled economically from its source and by the proximity of competing rock sources. As of 1981, the quantity of dolomite in the Tract 83 deposits suitable for riprap and other construction uses could likely satisfy the demand reasonably anticipated for approximately 25 years.

In November 1971, Mosby requested permission to survey, drill-test, and remove a rock from Tract 83 known as dolomite. The request was denied on November 18, 1971, on the ground that dolomite was not a mineral within the meaning of the reservation in the 1942 deed "because it is desired for use as rock and not for the extraction of any minerals therefrom." In response to this denial, petitioners reiterated their request, arguing that dolomite has a definite chemical composition; that the subject deposit could be quarried for 12-ton size rocks for use as riprap; that they had an oral contract to supply a minimum of 50,000 tons of dolomite riprap rock for use on a certain project at a price of $4 per ton; and that the Government's continued denial would jeopardize this oral contract and lead to legal action for damages in inverse condemnation. Permission, however, was still not granted.

On March 10, 1972, petitioners received from the McClellans a deed to real property in Tract 83:

> All oil, gas, asphaltum and other hydrocarbon substances and other minerals, including diatomaceous earth, in and under the land described below, together with all easements, roads, and privileges reasonably necessary to explore said land for, and to produce and transport therefrom any of said minerals.

At the time of the deed, petitioners knew that the United States claimed ownership of the subject dolomite deposits.

In April 1974, petitioners presented a claim to the Government under the Tort Claims Act for damages in the

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amount of $18,750,000, based on a deposit of 25 million tons, valued at a royalty rate of 75 cents a ton in place. Petitioners asserted that the dolomite deposit was ideally suited for economic and profitable extraction as riprap and that "it is not the dolomite mineral as such which is profitable to extract, but the dolomite rock as it exists in its natural state." In October 1974, the Government denied petitioners' claim on the ground that petitioners did not acquire any right to remove dolomite rock because it was not a mineral within the reservation clause of the 1942 deed and because the "anti-assignment statute" barred petitioners from asserting such a claim against the Government.

In February 1975, petitioners instituted a suit in the U.S. Court of Claims alleging entitlement to monetary relief on the ground that property had been taken without just compensation contrary to the mandate of the Fifth Amendment of the U.S. Constitution. See *Foster v. United States*, 221 Ct. Cl. 412 607 F.2d 943 (1979). Specifically, petitioners argued that the phrase "and other minerals" in the deed to the United States be interpreted under well-established principles to construe reservations in deeds in favor of the grantor; that the phrase was intended by the parties to include dolomite; and that it was common practice to employ this phrase to reserve all substances which can be extracted to yield value.

The Government raised five defenses: (1) Plaintiffs were barred by the Anti-Assignment Act, 31 U.S.C. sec. 203 (1976); (2) the deposits in question were not a mineral; (3) the deposits were not included in the mineral reservation; (4) there had been no taking of property; and (5) if the deposits were mineral deposits, and there had been a taking, the value thereof did not exceed $30,000. The Government conceded that the subject deposit would be within petitioners' ownership if it was a mineral and if it was contemplated by the customary reserve language used in California deeds.

The Trial Judge of the Court of Claims found that there had been a temporary taking and awarded plaintiffs $23,250. Upon review, the Court of Claims found that (1) plaintiffs' claim was not barred by the Anti-Assignment Act; (2) the dolomite deposits were a mineral; (3) the

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dolomite deposits were within the reservation of minerals retained by the seller in the sale to the United States; and (4) the Government's denial of access to the deposits constituted a permanent taking which occurred as of November 18, 1971, entitling plaintiffs to compensation under the Fifth Amendment. Thereupon, the matter of a determination of damages was left for further proceedings.

During the years in issue, petitioners deducted legal expenses incurred while pursuing the claim against the United States for inverse condemnation. Respondent disallowed the deductions on the ground that they were capital expenditures under section 263.[2]

Petitioners contend that they are entitled to current deductions under either section 162 or section 212 for legal fees incurred in connection with the Court of Claims proceeding. Petitioners, however, do not seek a deduction for legal fees incurred after the decision by the Court of Claims that there was a permanent taking, as there was then a binding judgment that an inverse condemnation had in fact occurred. Respondent's position is that the fees in dispute are not currently deductible but must be capitalized pursuant to section 263. Petitioners bear the burden of proving entitlement to the claimed deductions. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

One requirement for deductibility of an expenditure under either section 162 or section 212 is that the expenditure be "ordinary and necessary." Section 263, however, provides that no deduction shall be allowed for capital expenditures. Thus, an expenditure cannot be deducted as an ordinary and necessary expense under section 162 or section 212 if it is a capital expenditure. *Woodward v. Commissioner*, 397 U.S. 572, 576 (1970). As to whether an expenditure is ordinary and potentially deductible or capital and not deductible, sections 162 and 212 are in pari materia and need not be applied separately. See *United States v. Gilmore*, 372 U.S. 39, 44-45 (1963). Thus, we first address the threshold question of whether petitioners' legal fees were capital expenditures under section 263.

[2]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

Two types of expenditures that must be capitalized under section 263 are (1) those that involve the cost of the acquisition or disposition of a capital asset, *Woodward v. Commissioner*, *supra*; sec. 1.263(a)-1(a) and (e), Income Tax Regs.; and (2) those that involve the cost of defending or perfecting title to property, *Reed v. Commissioner*, 55 T.C. 32, 40 (1970); sec. 1.263(a)-2(c), Income Tax Regs.

Petitioners argue that the fees in issue are ordinary and necessary because they meet the primary purpose test, i.e., that although title was involved, the primary purpose of the suit was to enable them to conduct their quarry business. See *Industrial Aggregate Co. v. United States*, 284 F.2d 639 (8th Cir. 1960), and *Lewis v. Commissioner*, 253 F.2d 821, 827 (2d Cir. 1958), affg. 27 T.C. 158 (1956). Respondent contends, however, that the primary purpose test does not apply because it was specifically rejected in *Woodward v. Commissioner*, *supra*.

In *Woodward*, the Supreme Court denied taxpayers a current deduction for legal fees incurred in connection with the appraisal and acquisition of stock that the taxpayers were required to purchase from a minority shareholder. The Supreme Court held that in cases where the litigation involved the acquisition or disposition of a capital asset, the origin of the claim, not the primary purpose of the litigation, is the controlling test in deciding whether the expenditures should be capitalized. This Court subsequently extended the origin of the claim test to expenditures incurred in litigation of title to property. *Boagni v. Commissioner*, 59 T.C. 708 (1973); *Reed v. Commissioner*, *supra*.

The origin of the claim is the appropriate test for determining the deductibility of the legal fees incurred in a direct condemnation suit. *Madden v. Commissioner*, 514 F.2d 1149, 1151 (9th Cir. 1975), revg. 57 T.C. 513 (1972). In *Madden*, a taxpayer sought to deduct legal fees incurred in resisting a public utility's condemnation of taxpayer's land for use as a reservoir. Focusing on the nature of a condemnation proceeding, the Court of Appeals for the Ninth Circuit stated that a controversy where the Government attempts to appropriate taxpayer's land and taxpayer resists is "inherently related to the sale and acquisition of land." *Madden v. Commissioner*, 514 F.2d at 1151. There-

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upon, the court held that the origin of the claim test, as set out in *Woodward*, applied and denied the taxpayer's deduction. Subsequently, this Court adopted the origin of the claim test with regard to direct condemnation proceedings. *Soelling v. Commissioner*, 70 T.C. 1052 (1978).

Petitioners argue that an inverse condemnation is materially different from a direct condemnation. Specifically, petitioners contend that in a direct condemnation the Government establishes its need for a capital asset, files a Declaration of Taking, and sets out to acquire the property but that in an inverse condemnation the "key question is whether *any* taking occurred" as a result of the Government's unintended and "almost accidental" possession of, or interference with, an asset. We do not disagree with petitioners' analysis of the distinctions between direct condemnation and inverse condemnation; however, it does not convince us that the origin of the claim test should not be applied here. The reasons that the origin of the claim test was adopted over the primary purpose test in other cases equally apply to expenses incurred in an inverse condemnation suit. For example: (1) The origin of the claim is a simpler and more certain inquiry, *Woodward v. Commissioner*, *supra* at 577; (2) "A test based upon the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions," *Woodward v. Commissioner*, *supra* at 577; and (3) the origin of the claim requires an objective examination of all the facts, *Boagni v. Commissioner*, *supra* at 713, rather than a subjective analysis of a taxpayer's "purpose" or intent. Thus, the origin of the claim is the proper test for determining if expenditures incurred in an inverse condemnation must be capitalized.

In *Boagni v. Commissioner*, *supra*, we defined the origin of the claim test as follows:

> Quite plainly, the "origin-of-the-claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended,

the background of the litigation, and all facts pertinent to the controversy. [59 T.C. at 713. Citations and fn. ref. omitted.]

Applying these criteria to the facts herein, we hold that the origin of the claim involved the disposition of a capital asset.

Petitioners argue that their legal fees are deductible even applying the origin of the claim test. Petitioners contend that the fundamental issue was whether there had been a taking; that the nature and objective of the litigation was "to force the Government to allow them access to their mineral deposits" to conduct their business; and that the background of the litigation involved the Government's continued denial of access to the property. Based on these alleged factors, petitioners posit that the origin of the claim involved their profit-making activity, not the acquisition or disposition of a capital asset.

We disagree with petitioners' summary of the facts and with the result petitioners proffer. Before the litigation ensued, both parties claimed ownership of the deposits of dolomite. Petitioners filed their claim against the United States on the ground that their property had been "taken" by inverse condemnation. Prior to the trial, petitioners repeatedly attempted to gain access to the property. However, contrary to what petitioners suggest, they did not seek in the *litigation* to gain access to the disputed property to conduct a mining operation. Rather, they requested compensation under the Fifth Amendment, which the Court of Claims awarded on the basis of a "permanent taking." Thus, the nature of the claim involved the disposition of a capital asset.

Petitioners also argue that income from a temporary taking is ordinary and because the Trial Judge found a temporary taking, although the Court of Claims subsequently held that the taking was permanent, the legal fees in issue should be deductible ordinary expenses. Petitioners, however, are isolating and highlighting one step in the chain of events and ignoring all the other objective facts. A temporary taking presupposes that Government interference or possession will cease. This was not the nature of petitioners' claim; as already discussed, petitioners sought only monetary relief for the taking of their property, not

access to the property. Thus, the Trial Judge's finding of a temporary taking does not alter the result where all the objective facts indicate that the origin of the claim was in the disposition of a capital asset.

The legal fees must be capitalized under section 263.

Decision will be entered for the respondent in docket No. 24519-83.

Decision will be entered under Rule 155 in docket No. 24534-83.

ORANGE AND ROCKLAND UTILITIES, INC., ORANGE AND ROCKLAND UTILITIES, INC. AND SUBSIDIARIES; ROCKLAND ELECTRIC COMPANY, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10715-82. Filed February 18, 1986.

Petitioners, regulated public utility companies, reported income on an accrual calendar year basis. Petitioners employed the cycle meter reading method of accounting for tax purposes. Consequently, revenue generated for utility services furnished after the last cycle meter reading date in December was not accrued until after the close of the taxable year. Expenses related to such utility services were deducted in the taxable year such service was furnished to the customers. For financial statement purposes, petitioners accrued so-called unbilled revenue relating to utility services furnished between the last cycle meter reading date in December and the end of the calendar year. Because of the foregoing disparity between income recognition of unbilled revenue for Federal income tax and financial accounting purposes, respondent determined that unbilled revenue was accruable for tax purposes due to the conformity requirement within Rev. Rul. 72-114, 1972-1 C.B. 124. *Held*, the cycle meter reading method of accounting clearly reflects income under sec. 446(b), I.R.C. 1954, even though petitioners record unbilled revenue for financial accounting purposes. *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445 (1982), followed. *Held, further*, the cycle meter reading method of accounting is a permissible method of accrual accounting under sec. 446(c)(2), I.R.C. 1954.

John C. Richardson and *Alison E. Clapp*, for the petitioners.

David N. Brodsky, for the respondent.

HAMBLEN, *Judge*: Respondent determined deficiencies with respect to the Federal income tax liability of petitioners as follows:

Petitioner	*Year*	*Deficiency*
Orange & Rockland Utilities, Inc. (O & R)	1976	$4,239,516
Rockland Electric Co. (Rockland)	1976	2,813
Orange & Rockland Utilities, Inc., and Subsidiaries (O & R group)	1977	1,651,500

After concessions,[1] the issue presented for decision is whether petitioners may use the "cycle meter reading" method of accounting for Federal income tax purposes where such method does not conform to the method of accounting used by petitioners for financial statement and regulatory reporting purposes.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference.

O & R group is an affiliated group of corporations within the meaning of section 1504.[3] O & R, as parent of the O & R Group, filed a consolidated federal income tax return on behalf of the O & R group for the calendar yearend 1977. O & R filed a separate Federal income tax return for the calendar year 1976. Rockland is a member of the O & R group and was included in the 1977 O & R group consolidated Federal income tax return. Rockland filed a separate 1976 Federal income tax return.

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[1] Respondent concedes by stipulation of fact that certain fuel adjustments were improperly included as unbilled revenue within the statutory notices of deficiency.

[2] Respondent's determination that petitioners must accrue unbilled revenue with respect to utility service furnished between the last cycle meter reading date and the calendar yearend in prior taxable years necessitated computational adjustments to the following tax attributes: (1) The net operating loss carryforward to the 1977 O & R group return; (2) the investment credit carryforward to the 1976 O & R return; and (3) the net operating loss carryforward to the 1976 Rockland return.

[3] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioners are regulated public utilities. Petitioners have been engaged in the distribution of utility service for over 50 years and furnish utility service to approximately 275,000 customers. Petitioners maintained a principal place of business at Pearl River, New York. O & R furnished gas and electric service in southern New York State and was subject to regulation by the New York Public Service Commission and the Federal Power Commission. Rockland furnished electric service in northern New Jersey and was subject to regulation of the Board of Public Utility Commissioners of the State of New Jersey and the Federal Power Commission. Pike County Light & Power Co., an affiliated member of the O & R group included in the 1977 O & R group consolidated Federal income tax return, furnished gas and electric service in Pike County, Pennsylvania, and was subject to regulation by the Pennsylvania Public Utility Commission and the Federal Power Commission.

The applicable public utility commission regulations and rate tariffs did not permit petitioners, except in unusual credit situations, to bill customers more frequently than monthly or bimonthly depending upon the class of service. These regulations and tariffs provided for customer billing, except in unusual credit situations, only after a meter reading or an interim estimate. Petitioners could not bill customers prior to the next cycle meter reading date for utility service furnished between the last cycle meter reading date and the end of the calendar year unless new tariffs were submitted to and approved by the appropriate regulatory agencies.

Under the applicable public utility commission regulations and rate tariffs, petitioners were permitted to terminate service to a customer for nonpayment, except in unusual credit situations, only upon nonpayment of a bill, for a specified period and under specified circumstances.

The applicable public utility commission regulations and rate tariffs determined the allowable rates charged for utility service and varied depending upon usage, class of service, and demand.

In accordance with the applicable tariffs, petitioners billed customers monthly or bimonthly, depending on the class of service and related meter reading and billing cycle. As is

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customary within the industry, petitioners did not read all customer meters on the last day of each month. Petitioners assigned to each customer a certain date of each month for meter reading purposes. Petitioners read the meters of residential gas heating customers on the assigned date on a bimonthly basis and estimated the meter reading for interim months. For residential electric customers other than heat and hot water customers, petitioners also read the customers' meters on the assigned date on a bimonthly basis and estimated the meter reading for interim months. However, for residential heat and hot water electric customers and for commercial and industrial electric customers, petitioners read the customers' meters on an assigned date every month. The assigned date on which a customer's meter was read or was estimated for interim months where applicable is referred to herein as the "cycle meter reading date."

Petitioners prepared bills according to the applicable tariff rate schedules approximately 2 to 5 days after each cycle meter reading date. Large power customers were billed in the same manner. However, petitioners attempted to coordinate the cycle meter reading date for such customers with the close of each month.

From their incorporation over 50 years ago through and including the taxable years here involved, petitioners have consistently for Federal income tax purposes accrued revenue from sales of gas and electricity as income on the basis of their meter reading and billing cycles. Under this method, petitioners accrued as income all amounts billable during the year based upon their meter reading and billing cycles. In each year, therefore, petitioners accrued the gross income billable for the gas or electricity used (or, as to interim months, where applicable, estimated to have been used) for all cycle meter reading dates falling within the year. Accordingly, the income accrued during the year included the revenue for gas or electricity furnished to a customer between the last cycle meter reading date of the prior year and the end of such prior year. Income accrued during a current taxable year did not include the revenue for gas or electricity furnished to a customer between the last cycle meter reading date of that year and the end of

that year. Such income is sometimes referred to within the industry as "unbilled revenue."

Petitioners deducted for Federal income tax purposes the cost of producing and delivering gas and electricity delivered after the last meter reading date in the year through the end of the year, but did not deduct the cost of meter reading and billing for such gas and electricity as these activities had not been performed by the end of the year.

In contrast with the method of accounting used for Federal income tax purposes, petitioners recorded estimated unbilled revenue at the end of each year for book and financial accounting purposes, a financial reporting practice used for years beginning after December 31, 1969. For all prior years, petitioners used the cycle meter reading method of accounting for both financial statement and tax purposes.

The unbilled revenue was included in income by petitioners in all its certified financial reports submitted to shareholders, creditors, and regulatory agencies. The amount of unbilled revenue so recorded as income for book and financial accounting purposes was not, however, included within the accounts receivable in the financial accounts of petitioners but was instead included in a separate category entitled "accrued utility revenue."

The amount of "accrued utility revenue" for financial reporting purposes as of December of each year in issue for electric customers was determined as follows: An actual meter reading is taken for each customer whose meter is read on December 31 in a given class of customers. Approximately one-thirtieth of petitioners' customers are on a December 31 meter reading cycle. For residential electric customers, actual usage of December 31 cycle customers for the period ending December 31 is then compared with actual usage of such customers for the immediately preceding meter reading period to develop a growth factor. Then, for residential electric customers, the actual daily usage to the last meter reading date is multiplied by the growth factor thus developed and, in turn, by the number of days of usage to be estimated as "accrued utility revenue" for each such customer whose meter is not read on December 31. For commercial and industrial customers, actual daily

usage to the last meter reading date is multiplied by the number of days of usage to be estimated as "accrued utility revenue." The sum of "accrued utility revenue" thus determined for all customers is the total "accrued utility revenue" at December 31 of each year. The procedure for computing "accrued utility revenue" for gas customers is similar but includes, in place of the growth factor, a weather factor. Also, there is a daily "base load" for certain gas customers, which is not adjusted by the weather factor.

Petitioners and their outside accountants have no records or other evidence indicating that any test checks were performed, either by petitioners or by petitioners' outside accountants, to verify the method of calculating unbilled revenue prior to the implementation of the method.

However, after implementation of the method of computing unbilled revenue, both petitioners and their outside accountants checked to insure that the method had been correctly applied and that the results of such application were mathematically correct. This was done by applying the method manually to randomly selected customers and comparing the results with the computer-generated amount of unbilled revenue for each customer. In addition, the billing program, particularly that part of the program relating to estimated bills, was checked by petitioners by comparing the actual amounts reflected by a meter reading for a group of customers comprising an entire meter reading cycle with amounts calculated under the estimated billing procedure for the same customers for the period covered by the meter reading. The results of petitioners' checks of the billing program have shown, generally, that the program generates estimated bills which are reasonably accurate (varying from 90 percent to 105 percent of actual). This test check, however, is not a confirmation of the accuracy of the method used to determine unbilled revenue but rather a method to determine the accuracy of estimated interim billings generated under the billing program.

Petitioners' outside accountants, in connection with their annual examination of petitioners' consolidated financial statements, performed certain test checks and applied certain auditing procedures to petitioners' method of com-

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puting unbilled revenue. The test checks of unbilled revenue performed by petitioners' outside accountants indicated that the unbilled revenue calculation for 1976 was 93 percent accurate and such calculation for 1977 was 95-percent accurate.

Petitioners maintained workpapers as part of their permanent records that reconcile the method used in reporting for Federal income tax purposes the income from sales of gas and electricity with the method used for book and financial reporting purposes, and such a reconciliation is filed each year with respondent as part of petitioners' Federal income tax returns. Petitioners reported in Schedule M-1 to their Federal income tax returns for the taxable years here involved the difference between the method used in reporting for tax purposes the income from sales of gas and electricity and the method used for book and financial reporting purposes.

Petitioners' method of accounting for sales of gas and electricity for income tax purposes is a generally accepted practice employed in the utility industry for book and financial accounting purposes. The method of accounting for sales of gas and electricity which petitioners employed for book and financial accounting purposes also is a generally accepted accounting practice employed in the utility industry for book and financial accounting purposes. For book and financial accounting purposes, the majority of major public utilities did not during the years at issue and currently do not accrue as revenue gas or electricity delivered to the customer subsequent to the last cycle meter reading of the year. If petitioners had also employed the cycle meter reading method of accounting for book and financial accounting purposes, respondent would have accepted that method of accounting as clearly reflecting petitioners' income for Federal income tax purposes and would not have required petitioners to change their method of accounting to one that would require the accrual as income of gas and electricity delivered to customers subsequent to the last cycle meter reading of the year. See Rev. Rul. 72-114, 1972-1 C.B. 124.

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OPINION

We must determine (1) whether the cycle meter reading method of accounting which petitioner employed for tax reporting purposes clearly reflects income under section 446(b), and (2) if it does, whether such method is a permissible method under section 446(c).

This case is essentially identical to and indistinguishable from *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445 (1982), where we held that the cycle meter reading method of accounting clearly reflects income for Federal income tax purposes even though such method of income was not used for financial statement purposes and that respondent had abused his discretion under section 446(b) by requiring unbilled revenue to be included in income where the treatment of such revenue did not conform for income tax and financial reporting purposes. Respondent's position under section 446(b) in *Public Service Co. of New Hampshire* is a mirror reflection in this case. Our opinion in *Public Service Co. of New Hampshire* is dispositive of respondent's assertions that the cycle meter reading method of accounting fails to clearly reflect income within section 446(b), unless there is conformity between tax and financial reporting, and we must reject respondent's efforts to subsume us again in the conformity and clear reflection of income issue under section 446(b).

As in *Public Service Co. of New Hampshire*, respondent concedes that the cycle meter reading method of accounting clearly reflects income where such method is in conformity with the method of accounting used for financial statement purposes. Nevertheless, where such conformity is absent, respondent asserts that the cycle meter reading method fails to clearly reflect income. See Rev. Rul. 72-114, *supra*. Respondent, therefore, premises his argument upon the existence vel non of conformity because, in his view, conformity is required to insure the clear reflection of income. However, respondent has not shown us a common denominator that predicates a correlation between conformity of income tax and financial accounting reporting practice and the clear reflection of income sufficient to condition the use of the cycle meter reading method of

accounting upon such conformity. *Public Service Co. of New Hampshire v. Commissioner, supra*; cf. *Bay State Gas Co. v. Commissioner*, 689 F.2d 1, 6 (1st Cir. 1982), affg. 75 T.C. 410, 420 (1980); see generally Dubroff, Cahill & Norris, "Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles," 47 Albany L. Rev. 354 (1983). We perceive no meaningful distinction between petitioners' reporting practice and that of similarly situated public utilities which do conform tax and financial reporting practices as directed by respondent within Rev. Rul. 72-114, *supra*.

We conclude again and reiterate that petitioners' use of the cycle meter reading method of accounting clearly reflects income and that respondent abused his discretion by requiring income recognition of unbilled revenue merely due to the absence of conformity of such treatment between Federal income tax purposes and financial statement purposes. See *Public Service Co. of New Hampshire v. Commissioner, supra*.

However, in *Public Service Co. of New Hampshire* we declined to consider respondent's argument that the cycle meter reading method of accounting is a hybrid method of accounting not specifically permitted under section 446(c) because respondent's notice of deficiency failed to specify such a contention and the notice of deficiency was not supplemented by respondent's answer. *Public Service Co. of New Hampshire v. Commissioner, supra* at 454. Nevertheless, as the requirement that a taxpayer's method of accounting clearly reflects income under section 446(b) is in addition to the requirements of sections 446(a)[4] and 446(c), respondent was permitted to amend his answer by order of this Court subsequent to our decision in *Public Service Co. of New Hampshire*. In the amendment to answer, respondent posits that *Public Service Co. of New Hampshire* is not controlling because respondent's central legal position under section 446(c), that the cycle meter reading method of accounting is not a permissible method of accounting for income tax purposes where such method does not conform

[4]As in *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445 (1982), respondent does not argue that sec. 446(a) denies petitioners the opportunity to use the cycle meter reading method of accounting to compute taxable income.

to the method used for financial reporting purposes, was not addressed by the Court. Respondent bears the burden of proof as to the matters pertaining to section 446(c) and the Court so noted in its order granting respondent's motion to amend his answer herein. Rule 142(a). In addressing respondent's section 446(c) assertions within the amendment to his answer, we discern the thrust of respondent's arguments to be as follows:

(1) Petitioner's unbilled revenue is currently accruable under the all events test within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs.

(2) Because petitioners do not accrue unbilled revenue for tax purposes, the cycle meter reading method is not a specifically permitted method of accounting described in the Internal Revenue Code and regulations thereunder.

(3) Respondent may authorize the use of a method of accounting not otherwise described in the Internal Revenue Code and regulations thereunder if, in the opinion of the Commissioner, such method clearly reflects income. Sec. 1.446-1(c)(1)(ii), Income Tax Regs.

(4) The imposition of a condition of conformity between tax and financial accounting is a proper exercise of respondent's broad discretion within section 1.446-1(c)(2)(ii), Income Tax Regs., and is necessary to insure that the cycle meter reading method of accounting clearly reflects income.

(5) Since petitioners use a method which accrues unbilled revenue for financial statement purposes and use the cycle meter reading method for tax purposes, petitioners' method of accounting fails to clearly reflect income.

Respondent asserts that section 446(c) and section 1.446-1(c)(2)(ii), Income Tax Regs., provide him wide latitude to establish conditions to insure that a method of accounting not specifically permitted under section 446(c) clearly reflects income. Respondent also asserts that the cycle meter reading method of accounting is not a specifically permitted method under section 446(c), and that the conformity requirement of Rev. Rul. 72-114, *supra* is a proper exercise of authority under section 1.446-1(c)(2)(ii), Income Tax Regs. Although we did not reach the "permissible method" issue under section 446(c) in *Public Service Co. of New Hampshire*, our opinion there is a foundation for and foreshadows

the determination we make here. In *Public Service Co. of New Hampshire* we indicated that:

> Whether petitioner's unbilled December revenues are properly accruable in December within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs., is the linchpin of respondent's argument under section 446(c), because if they are not properly accruable, then petitioner's meter reading and billing cycle method of accounting is an accrual method within the meaning of respondent's regulations, and as such, it is a "permissible method" pursuant to section 446(c)(2). That is, respondent's arguments under section 446(c)(4) are premised on our finding that petitioner's method of accounting is a "hybrid" * * * rather than an accrual method. * * * [*Public Service Co. of New Hampshire v. Commissioner, supra* at 453-454; citations omitted.]

We also noted that the billing requirements of the applicable public utility commission regulations and rate tariffs "may well be critical with respect to the issue of accruability." *Public Service Co. of New Hampshire v. Commissioner, supra* at 454-455.

The method of accounting used by a taxpayer to determine when income is recognized will be accepted as a permitted method of accounting if such method comports with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the regulations. Sec. 1.446-1(c)(1)(ii), Income Tax Regs.

The cycle meter reading method of accounting is in accord with generally accepted accounting principles and is predominate in use within the utilities industry. See *Public Service Co. of New Hampshire v. Commissioner, supra* at 456; *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 15 (1974); *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 556 (1979), affd. 633 F.2d 512 (7th Cir. 1980). It has long been considered a generally accepted accounting principle for utilities to accrue revenues based on either cycle meter readings or bills rendered basis with no accounting recognition of unbilled revenue, and certified public accountants issue unqualified financial statements prepared so as to accrue revenue when meters are read or the consumer is billed. Financial statements which reflect unbilled revenue also are prepared in accordance with generally accepted accounting principles. Petitioners have consistently used the cycle meter reading method of ac-

counting for tax purposes from incorporation over 50 years ago through the tax years in issue and for financial statement purposes from incorporation through the year ended December 31, 1969.

The issue as to whether the cycle meter reading method of accounting is a permissible method of accounting must focus upon the determination as to whether such method is consistent with the regulations. Section 1.446(c)(1)(ii), Income Tax Regs., states that "Generally under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. "Accordingly, the cycle meter reading method of accounting which operates to defer unbilled December revenue, will be a permissible method of accrual accounting within section 446(c)(2) if all events which fix petitioners' right to receive such unbilled revenue have not occurred as of December 31 of each year in issue or the amount thereof cannot be determined with reasonable accuracy. Sec. 1.446-1(c)(1)(ii), Income Tax Regs. Respondent asserts that unbilled December revenue is properly accruable as of December 31 of each year in issue and that the cycle meter reading method of accounting is not specifically authorized by the Internal Revenue Code on the regulations thereunder. Accordingly, respondent posits that the cycle meter reading method of accounting is a variation or combination of an accrual method of accounting within the meaning of section 446(c)(4) and that respondent's imposition of the conformity requirement in order to insure the clear reflection of income is a proper exercise of respondent's authority under section 1.446-1(c)(2)(ii), Income Tax Regs.

Respondent asserts that the delivery of utility services after the last cycle meter reading date in December fixed petitioners' right to receive unbilled revenue accrued for financial statement purposes as of December 31 of each year in issue, and respondent cites *Bay State Gas Co. v. Commissioner*, *supra*, secs. 1.446-1(c)(1)(ii) and 1.471-1, Income Tax Regs., and *City Gas Co. of Florida v. Commissioner*, T.C. Memo. 1984-44, to support his contention.

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Respondent relies on the opinion of the Court of Appeals for the First Circuit in *Bay State* for the proposition that delivery of utility service after the last cycle meter reading date in December was sufficient under the strict rules of accrual accounting to require income recognition of unbilled revenue because delivery fixed the customer's obligation to pay for utility services and the amount thereof was reasonably capable of determination. The issue before us here, however, whether under the cycle meter reading method, unbilled December revenue is properly accruable as of December 31 of each year within the meaning of section 1.446-(c)(1)(ii), Income Tax Regs., was not decided in *Bay State* by either the Court of Appeals for the First Circuit, *Bay State Gas Co. v. Commissioner*, 689 F.2d at 5, or by this Court. The Court of Appeals for the First Circuit stated in *Bay State* that the "Tax Court correctly recognized, implicitly if not explicitly, that, under a strict accrual method, income for the calendar year would have resulted from late December sales to both regular and budget billing customers." *Bay State Gas Co. v. Commissioner*, 689 F.2d at 5.[5] However, neither the opinion of that court nor our opinion in *Bay State* reached the issue as to whether the company's unbilled revenues were properly accruable in December within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs. Cf. *Public Service Co. of New Hampshire v. Commissioner*, *supra* at 454. The issue for decision in *Bay State* was whether respondent, having permitted the company to use the cycle meter reading method of accounting for tax purposes as provided in Rev. Rul. 72-114, *supra*, could require the company to accrue revenue generated by the delivery of gas to the company's "budget billing" customers.[6] Respondent had determined that, as to budget billed customers, the cycle meter reading method of accounting did not clearly reflect income to the extent an

[5] As the fundamental issue of accruability under the all events test concerning the circumstances presented here was not before the Court of Appeals for the First Circuit in *Bay State Gas Co. v. Commissioner*, 689 F.2d 1 (1st Cir. 1982), affg. 75 T.C. 410 (1980), respondent's reliance upon that court's language relating to accruability under the all events test is misplaced as *Bay State* should be read only in the context of the issue there decided.

[6] In *Bay State* the gas company offered residential gas customers a budget billing plan whereby gas costs for the entire heating season were estimated in advance such that the customer was billed a pro rata portion of the entire heating season estimate each month, with an adjustment for actual usage at the end of the heating season.

excess budget bill was estimated as of the assigned cycle meter reading date where gas had subsequently been delivered, but payment had not been received prior to the end of the taxable year.[7]

In *Bay State*, we stated that "Except to the extent that they [the company] show the customer's actual or estimated usage of gas through the last cycle meter reading date, the monthly statements * * * [the company] * * * sends its budget billing customers are not enforceable bills." *Bay State Gas Co. v. Commissioner*, 75 T.C. at 421. We also stated that differing accounting treatment might be justified if the budget bills were legally enforceable or if the budget bills were in fact paid prior to the close of the taxable year, although, under the applicable utility commission regulations, all customers had precisely the same payment obligations. *Bay State Gas Co. v. Commissioner*, 75 T.C. at 423. Therefore, in *Bay State*, we held that the company's method of accounting as to budget billing customers clearly reflected income because we found no meaningful distinction in the payment obligations of budget billing customers as compared to the company's regular billing customers. In *Bay State*, we focused on the occurrence of the cycle meter reading date because such date fixed the company's right to receive income as provided within the applicable public utility commission regulations. *Bay State Gas Co. v. Commissioner*, 75 T.C. at 420-421.

We believe that our analysis in *Bay State* is equally applicable to the present case. Under the pertinent public utility commission regulations and rate tariffs, petitioners were not entitled to bill unbilled revenue or pursue an enforceable right to such revenue until after the occurrence of the cycle meter reading date in the following January. Consequently, all events which fix petitioners' right to receive unbilled December revenue have not occurred as of December 31 of each year in issue. The applicable public utility commission regulations and rate tariffs are such that

[7] In *Bay State*, the company conceded that, to the extent that a budget billing customer has in fact paid the December budget bill during that month, it must accrue as income an amount to the extent that such customer has in fact paid for gas consumed during the taxable year. *Bay State Gas Co. v. Commissioner*, 689 F.2d at 6; 75 T.C. at 420. See also *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Association v. United States*, 367 U.S. 687 (1961).

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the critical event necessary to fix petitioners' right to receive unbilled December revenue is the occurrence of the respective cycle meter reading date which does not take place until the following January. In order to bill at other intervals, petitioners would have to obtain approval from the appropriate regulatory agency. Furthermore, termination of service was subject to the terms and conditions specified within the applicable public utility commission regulations and rate tariffs. We conclude, therefore, that for tax purposes, the cycle meter reading date in the following January, which fixed the billing requirements and terms of regulated performance, is the critical event necessary to fix petitioners' right to receive income generated by service provided between the last cycle meter reading date in December and the end of the taxable year. We note that a "strict method" of accrual accounting used by petitioners for financial statement purposes does recognize unbilled December revenue and that such method is in accord with generally accepted accounting principles. However, generally accepted accounting principles are not dispositive of characterization for tax purposes. *Thor Power Tool v. Commissioner*, 439 U.S. 522 (1979). Furthermore, the cycle meter reading method of accounting also is an accrual method which is in accord with generally accepted accounting principles and is in predominate usage within the utility industry. We find that, for income tax purposes, the cycle meter reading date in the following January is the critical event necessary to properly accrue unbilled December revenue within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs. The effect of the regulatory and tariff requirements preclude any other holding. See *Commissioner v. Idaho Power Co.*, *supra* at 15.

Respondent relies upon *City Gas Co. of Florida v. Commissioner*, *supra*, for the assertion that petitioners are manufacturing companies which must accrue income upon delivery and that the act of billing is not a factor within the all events test. See sec. 1.446-1(c)(1)(ii), Income Tax Regs. *City Gas* is distinguishable as that case concerned the appropriate characterization and time of recognition concerning certain advance deposits received by a gas company. Whether unbilled revenue is properly accruable within

the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs., was not at issue in *City Gas*. Respondent's reliance upon *City Gas* for the assertion that petitioners are manufacturers which must accrue income upon delivery, whether or not billed, is misplaced as that opinion does not characterize petitioners as manufacturers for purposes of the all events test within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs.

We recognize that under the regulations manufacturers accrue income as of delivery, whether or not billed. Sec. 1.446-1(c)(1)(ii), Income Tax Regs.; *Bentley Laboratories, Inc. v. Commissioner*, 77 T.C. 152, 165 (1981). We, however, are of the view that petitioners, as regulated public utility companies, provide services as so classified by the accounting profession in Accounting Research Study No. 7.[8] Furthermore, we distinguish the event which renders services as billable from the mere ministerial act of billing. We note that underAccounting Principles Board, Statement No. 4, revenue from services rendered is recognized when services have been performed and are billable.[9] The billing and termination of service regulations and rate tariffs of the applicable public utility commissions are such that the occurrence of the respective cycle meter reading date in January is the critical event necessary to fix petitioners' right to unbilled December revenue and renders such services billable. Billing is purely a ministerial act which has no effect on petitioners' revenue recognition treatment. Petitioners accrue revenue as of the cycle meter reading date, not the billing date.

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[8] Accounting Research Study No. 7 provides:

* * * * * * *

Recognition at time of sale.

In the case of businesses selling services, such as public utilities, the act or process of furnishing service, together with invoicing usually provides the occasion for recognition of revenue. * * *

[American Institute of Certified Public Accountants, Accounting Research Study No. 7, P. Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises 76-77 (1965).]

[9] Accounting Principles Board, Statement No. 4 provides in relevant part:

"Revenue from sales of products is recognized under this principle at the date of sale, usually interpreted to mean the date of delivery to customers. Revenue from services rendered is recognized under this principle when services have been performed and are billable. * * *"

[AICPA, A.P.B. Accounting Principles Statement No. 4, at 9086 (1970).]

In *Decision, Inc. v. Commissioner*, 47 T.C. 58, 63 (1966), we held that all events which fixed the rights of an accrual basis advertising concern had not occurred as of the end of the taxable year where the terms of the contractual arrangement provided that the contract was not billable and payment not due until the following taxable year. Furthermore, in *Cox v. Commissioner*, 43 T.C. 448, 457 (1965), we held, in part, that unbilled fees relating to investment management services were not accruable where the unbilled fees were not payable under the terms of the contract until billed and supported by services rendered. Our opinions in *Decision, Inc.* and *Cox* are applicable here where the pertinent public utility commission regulations and rate tariffs provide that unbilled December revenue is not billable and termination of regulated performance not permissible until after the occurrence of the respective cycle meter reading date in January.

We hold that all events which fixed petitioners' right to receive unbilled December revenue had not occurred as of December 31 of each year in issue. Consequently, the cycle meter reading method of accounting is a permissible method of accrual accounting within the meaning of section 1.446-1(c)(1)(ii), Income Tax Regs., and respondent abused his discretion by requiring petitioners to adopt a method of accounting other than the cycle meter reading method of accounting for tax purposes. Since we have determined that the cycle meter reading method is a specifically permitted accrual method of accounting within section 446(c)(2), respondent's imposition of a condition of conformity was an abuse of discretion as respondent's discretion within section 1.446-1(c)(2)(ii), Income Tax Regs., is relevant only to determine whether a method of accounting not specifically permitted clearly reflects income. *Pierce Ditching Co. v. Commissioner*, 73 T.C. 301, 305 (1979).[10] We have reached

[10] In *Pierce Ditching Co. v. Commissioner*, 73 T.C. 301 (1979), a cash basis construction company had historically accrued as a deduction bonuses for its employees determined at yearend and paid within 2½ months after the close of the taxable year. Respondent had audited the company for several years without adjustment as to this "hybrid" method of accounting. We determined there that a hybrid method of accounting was employed and that respondent's prior examination without adjustment was not a "positive act" sufficient for this Court to find that respondent had approved such hybrid method by exercising his authority granted under sec. 1.446-1(c)(2)(ii), Income Tax Regs. We have determined here that the cycle meter reading method of accounting is an accrual method specifically permitted under sec. 446(c)(2) and that such method of accounting clearly reflects income under sec. 446(b). No

our determination irrespective of the burden of proof which was placed on respondent by Order of this Court.[11]

We also reach our determination notwithstanding the fact that all events which fix petitioners' liability for expenses related to unbilled December revenue have occurred as of December 31 of each year in issue. As in *Public Service Co. of New Hampshire v. Commissioner*, 78 T.C. 445 (1982), we recognize that the cycle meter reading method of accounting operates to mismatch revenue recognition and related expenses (*Public Service Co. of New Hampshire v. Commissioner, supra* at 457), and that the matching of revenues and related expenses is a desirable objective. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 11 (1974); *American Automobile Association v. United States*, 367 U.S. 687, 692 (1961). However, it is well established that the matching of revenue recognition and related expenses is not absolutely essential. *Public Service Co. of New Hampshire v. Commissioner, supra* at 457; e.g., *Schlude v. Commissioner*, 372 U.S. 128 (1963). The result here is one of a timing difference which operates to defer income recognition of unbilled December revenue, but it is quite clear from the context of the applicable public utility commission regulations and rate tariffs that petitioners have not deliberately manipulated its income recognition procedure so as to prevent income from accruing that petitioners otherwise would have become entitled to receive as of December 31 of each year in issue. We are of the view that in the context of the public utility industry, the matching of revenue and related expenses is an inconsequential factor to our determination that the cycle meter reading method of accounting clearly reflects income and is a permissible method of accrual accounting.

"hybrid" method is involved here, respondent's assertion to the contrary notwithstanding. Therefore, respondent's reliance on *Pierce Ditching Co.*, and sec. 1.446-1(c)(2)(ii), Income Tax Regs., is misplaced, and the Court's holding there is irrelevant to our determination here.

[11] We note, however, that respondent has not carried his burden of proof here. Respondent also asserts that unbilled December revenue may be determined with reasonable accuracy within the meaning of sec. 1.446-4(b)(iii), Income Tax Regs., as evidenced by certain test checks performed by petitioners' outside accountants with respect to unbilled revenue amounts as of Dec. 31, 1976 and 1977. We have determined that the applicable public utility commission regulations and rate tariffs are such that the occurrence of the respective cycle meter reading date after the close of the taxable year is critical to the proper accrual of unbilled December revenue. Therefore, we find it unnecessary to address respondent's assertion as to the reasonable accuracy of petitioners' calculation of unbilled revenue estimated for financial statement purposes.

We conclude that this so-called misnomity, if any, is incidental and not inconsistent.

In view of the applicable public utility commission regulations and rate tariffs, we determine that petitioners' method of accounting for tax purposes clearly reflects income under section 446(b) and that petitioners' method of accounting for tax purposes is a permissible method of accrual accounting within section 446(c)(2). Based on the foregoing,

Decision will be entered under Rule 155.

EARL DROWN CORPORATION, ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 3350-82, 3351-82, 3352-82. Filed February 24, 1986.

Petitioners were the general partners of DNA, which was a wholesale distributor of magazines and paperback books of various publishers. DNA annually would borrow money from DPI and the Drown Trust to help fund December payments to publishers. During the years in issue, DNA purchased tax-exempt bonds from excess funds generated from its business. At the time of such purchases, DNA reasonably could have foreseen that a loan probably would be necessary to satisfy its future economic needs, which were of an ordinary, recurrent nature. *Held*, the interest expense deducted by DNA for interest paid to DPI and the Drown Trust was nondeductible interest paid on an "indebtedness incurred or continued to purchase or carry" tax-exempt securities within the meaning of sec. 265(2), I.R.C. 1954.

James H. Knecht, for the petitioners.
Gregory A. Roth, for the respondent.

STERRETT, *Chief Judge*: In these consolidated cases, respondent determined, by notices dated December 31, 1981, deficiencies in petitioners' Federal income taxes as follows:

[1] Cases of the following petitioners are consolidated herewith: Blanche Drown Corp., docket No. 3351-82; and Jack A. Drown and Helene C. Drown, docket No. 3352-82.

Docket No.	*Petitioner*	*Tax year ended*	*Deficiency*
3350-82	Earl Drown Corp.	11/30/77	$3,207
		11/30/78	1,160
3351-82	Blanche Drown Corp.	11/30/77	3,257
		11/30/78	1,172
3352-82	Jack A. Drown and Helene C. Drown	12/31/76	25,625
		12/31/77	8,000

After concessions, the sole issue before the Court is whether the interest expense deducted by Drown News Agency for interest paid to the Drown Trust and to Drown Periodicals, Inc., was nondeductible interest paid on an "indebtedness incurred or continued to purchase or carry" tax-exempt securities pursuant to section 265(2), or deductible pursuant to section 163.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

Petitioner Earl Drown Corp. (hereinafter EDC) and petitioner Blanche Drown Corp. (hereinafter BDC) are California corporations and at all relevant times have had their principal places of business at 15172 Golden West Circle, Westminster, California. Petitioners Jack A. Drown and Helene C. Drown are husband and wife and at all relevant times resided in Rolling Hills, California. During the years in issue, EDC and BDC maintained their books and records and filed their corporate income tax returns under the cash method of accounting, and Jack A. and Helene C. Drown filed their joint Federal income tax returns under the cash method of accounting. All such income tax returns were filed with the Internal Revenue Service Center in Fresno, California.

During the years in issue, EDC, BDC, and Jack A. Drown were the general partners of Drown News Agency, a California general partnership (hereinafter DNA), and their

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in issue.

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shares of partnership capital and profits and losses were 25 percent, 25 percent, and 50 percent, respectively. During this period, Jack A. Drown, Helene C. Drown, and Sara Samuelson, an employee of DNA, were the directors of EDC and BDC, and Jack A. Drown was president and Helene C. Drown was vice president of EDC and BDC. All of the issued and outstanding stock of EDC and BDC was, and continues to be, held by Jack A. Drown and Everett Morris, as trustees, under a Declaration of Trust executed on December 14, 1956, by Earl E. Drown and Blanche A. Drown, as trustors (hereinafter the Drown Trust). The beneficiaries of the Drown Trust are Jack A. Drown, Helene C. Drown, and their issue.

DNA is a wholesale distributor of magazines and paperback books of various publishers in and around Los Angeles, California. DNA was started in 1938 by Jack A. Drown and his father Earl E. Drown, who were equal partners. Jack A. Drown's partnership interest is the community property of his wife, Helene C. Drown, and Earl E. Drown's partnership interest was the community property of his wife, Blanche A. Drown.[3] Since 1961, Jack A. Drown has been the managing partner of DNA. DNA's offices and warehouses are located at 15172 Golden West Circle, Westminster, California, and DNA files its income tax returns on a calendar year basis. Prior to 1982, DNA kept its books and filed its income tax returns under the cash method of accounting. In 1982, DNA requested and was granted permission by the Commissioner to change its method of accounting to the accrual method.

Prior to the change from the cash to the accrual method of accounting, DNA attempted each year to have its cash basis income approximate the amount of income that it estimated would have been reported under the accrual method of accounting.[4] This was accomplished by DNA determining its pro forma accrual basis income based upon its historic rate of accrual basis gross profit and then

[3] Subsequent to the deaths of Earl E. Drown on May 6, 1961 and Blanche A. Drown on Dec. 19, 1967, their partnership interests in DNA passed under their respective wills to the Drown Trust and said interests were transferred to EDC and BDC in exchange for all of the issued and outstanding stock of the respective corporations.

[4] DNA's practice of attempting to have its cash basis income approximate accrual basis income dates back to at least the 1940's, and possibly to the inception of DNA's business in 1938.

controlling its cash disbursements during December. Typically, DNA received invoices during each month from the publishers for shipments of magazines. Then at the end of the month, it received a statement from each respective publisher for the gross amount of these invoices. With the exception of December's statement, DNA subtracted from the gross amount credits for returned magazines and submitted payment to the various publishers for the net amount. In order to achieve the desired amount of cash basis income, DNA paid to approximately 12 to 15 of the larger publishers the gross amount of the December billings without subtracting the credits for returned magazines. As a consequence, the December payments were substantially more than the amounts paid during the other months and, to the extent its cash was insufficient, DNA borrowed funds to make these payments.[5]

Most of these funds were borrowed from Bank of America where DNA had established overdraft lines of credit. Borrowings were made on a daily basis as checks to publishers were presented to the bank for payment, and repayments were made daily as DNA made deposits to its account. DNA owned tax-exempt municipal bonds that were held by Bank of America as security for the repayment of these loans.

DNA began to purchase tax-exempt municipal bonds in or around 1964. These bonds were purchased with surplus cash upon the advice of DNA's investment counselors, and such holdings at December 31, 1971, and at each yearend through 1978, at cost, were as follows:

Year	*Amount*
1971	$1,088,950
1972	1,204,397
1973	1,603,120
1974	1,722,619

[5] From 1972 to 1979, the comparison of December payments to payments made during the preceding and succeeding months are as follows:

Year	*October*	*November*	*December*	*January*	*Year*
1972	$794,691	$842,406	$2,417,051	$96,738	1973
1973	882,396	756,605	2,795,661	11,751	1974
1974	1,359,561	1,518,696	3,858,327	145,979	1975
1975	1,455,962	1,637,953	3,844,571	36,561	1976
1976	2,069,101	1,970,884	3,849,489	310,561	1977
1977	2,202,077	2,162,811	3,848,947	564,826	1978
1978	2,379,771	1,972,411	3,923,966	647,512	1979
Total	11,143,559	10,861,766	24,538,012	1,813,928	Total

Year	*Amount*
1975	$2,908,235
1976	[6]3,227,172
1977	[6]3,920,173
1978	[6]4,628,769

During the years in issue, DNA kept its tax-exempt municipal bonds in a custodianship bond account at the trust department of Bank of America. The bank would collect the cash from interest coupons, from redemptions at maturity, and from sales, and it would purchase new bonds upon the advice of DNA's broker, Blyth Dillman. As excess cash accumulated from business operations, DNA transferred funds to the bond account. Payments of cash by DNA into the bond account for the purchase of additional bonds, exclusive of reinvested collections of interest and proceeds of redemptions and sales during 1976 through 1978, were as follows:

	1976	*1977*	*1978*
January	---	---	---
February	---	---	---
March	---	$500	---
April	---	---	$505,000
May	---	---	---
June	---	23,400	---
July	---	270,520	---
August	$395,000	---	---
September	---	11,950	---
October	---	138,741	---
November	---	59,810	18,618
December	---	---	---
Total	395,000	504,921	523,618

In addition to the funds borrowed from Bank of America, DNA also received the proceeds from unsecured loans from its related entities Drown Properties, Inc. (hereinafter DPI)[7]

[6] These bonds represented 72.7 percent of DNA's $4,439,439 in total assets as of Dec. 31, 1976, and 83.1 percent of DNA's $4,716,872 in total assets as of Dec. 31, 1977. The record was incomplete with respect to DNA's total assets as of Dec. 31, 1978, so we could not determine what percent of total assets DNA's bond . oldings represented at that time.

[7] DPI was organized as a California corporation in 1959 for the purpose of acquiring real property, vehicles, equipment, and other assets to be leased to DNA for use in its wholesale magazine and paperback book distribution business. DPI has since expanded its business to include the acquisition of other investment properties and related activities. During 1976 and 1977, one-half of the issued and outstanding stock of DPI was owned by DNA and the remaining stock was owned by the Drown Trust.

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and the Drown Trust on four occasions during 1973, 1975, 1976, and 1977, and used those proceeds to pay publishers at yearend or reduce the amounts borrowed from Bank of America. The amounts of the loans and the balances due DPI and the Drown Trust from time to time between February 1, 1973, and December 31, 1978, were as follows:

	DPI		*Drown Trust*		
Date	*Loan*	*Repay*[8]	*Loan*	*Repay*[8]	*Outstanding balance due*
02/01/73	$150,000	---	$100,000	---	$250,000
04/13/73	---	$50,000	---	---	200,000
12/31/73	---	---	---	---	200,000
12/13/74	---	20,000	---	---	180,000
12/31/74	---	---	---	---	180,000
01/13/75	---	---	70,000	---	250,000
04/14/75	---	---	---	$11,387	238,613
12/30/75	---	43,708	---	---	194,905
12/31/75	---	---	---	---	194,905
12/29/76	295,000	---	200,000	---	689,905
12/31/76	---	---	---	---	689,905
05/03/77	---	331,292	---	358,613	---
12/29/77	230,000	---	347,000	---	577,000
12/31/77	---	---	---	35,500	541,500
01/23/78	---	230,000	---	---	311,500
02/27/78	---	---	---	150,000	161,500
04/14/78	---	---	---	10,000	151,500
11/06/78	---	---	---	300,000	(148,500)
12/31/78	---	---	---	---	(148,500)

Interest accrued on the outstanding balances to DPI and the Drown Trust at the rate of 6 percent per annum. DNA paid interest to DPI of $19,138 and $6,440 for the taxable years 1976 and 1977, respectively, and to the Drown Trust of $37,519 and $10,792 for the taxable years 1976 and 1977, respectively. Said payments of interest were deducted by DNA on its income tax returns for 1976 and 1977, respectively. In his statutory notices of deficiency, respondent disallowed these claimed interest deductions.[9] The disallow-

[8] DNA's accounts with DPI and the Drown Trust also were debited and credited periodically for various other payments made or funds received by DNA for the accounts of the other entities, or for payments made or funds received by the other entities for the account of DNA.

[9] Respondent also disallowed the claimed interest deductions taken with respect to the funds borrowed from Bank of America. Petitioners have stipulated that such disallowance was proper.

ance was based upon his determination that the interest expense was on indebtedness incurred to purchase or carry tax-exempt obligations within the meaning of section 265(2).

OPINION

The sole issue for our resolution is whether DNA may deduct interest expense incurred with respect to loans from its related entities DPI and the Drown Trust. Section 163(a) allows a deduction for all interest paid or accrued on indebtedness within a taxable year. Section 265(2), however, disallows such interest deduction for interest paid "on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from * * * taxes."

The purpose of section 265(2) is to prevent a taxpayer from obtaining a double tax benefit by deducting interest on borrowed funds which enable the taxpayer to purchase or carry securities bearing tax-exempt interest. *Denman v. Slayton*, 282 U.S. 514, 515 (1931). Section 265(2), however, does not become operative merely by the simultaneous existence of an indebtedness and the holding of tax-exempt obligations. *Bradford v. Commissioner*, 60 T.C. 253, 257-258 (1973). Rather, this disallowance provision applies when the facts demonstrate that the purpose of incurring or continuing indebtedness is to purchase or carry tax-exempt securities. *Phipps v. United States*, 188 Ct. Cl. 531, 539-540, 414 F.2d 1366, 1372 (1969); *New Mexico Bancorporation v. Commissioner*, 74 T.C. 1342, 1352-1353 (1980). Although his intentions are relevant, the determination of the taxpayer's purpose is not dependent upon subjective factors and may be inferred from objective factors such as his conduct and the circumstances that confronted him. *Indian Trail Trading Post, Inc. v. Commissioner*, 60 T.C. 497, 500 (1973), affd. 503 F.2d 102 (6th Cir. 1974); *Israelson v. United States*, 367 F. Supp. 1104, 1107 (D. Md. 1973), affd. without published opinion 508 F.2d 838 (4th Cir. 1974). Resolution of this issue requires an inquiry into the connection and relationship between the tax-exempt securities and the indebtedness. The prohibited purpose must be established by the showing of a sufficiently direct relationship between the indebtedness and the exempt securities. *Wisconsin Cheese-*

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man, Inc. v. United States, 388 F.2d 420, 422 (7th Cir. 1968); *Investors Diversified Services, Inc. v. United States*, 216 Ct. Cl. 192, 200, 575 F.2d 843, 848 (1978); *Illinois Terminal Railroad Co. v. United States*, 179 Ct. Cl. 674, 682-683, 375 F.2d 1016, 1020-1021 (1967); *New Mexico Bancorporation v. Commissioner, supra* at 1353.

Respondent maintains that the interest paid by DNA to the Drown Trust and to DPI was nondeductible interest paid on an "indebtedness incurred or continued to purchase or carry" tax-exempt securities, and he relies primarily on *Wisconsin Cheeseman, Inc., supra*, as support for his position. We agree with respondent.

In *Wisconsin Cheeseman, Inc.*, the taxpayer had a seasonal business and the bulk of its sales were made during the last 3 months of each calendar year. During these last 3 months the taxpayer's cost of production was highest, which created a shortage of working capital. To meet its need for working capital, the taxpayer annually obtained short-term loans, which were repaid as receipts from its sales were collected. The balance of the receipts was used to purchase both tax-exempt bonds and taxable treasury bills. The treasury bills were used, as they matured, to meet the off-season needs of the business. The tax-exempt bonds were used as collateral for the bank loans during the next business cycle.

The Commissioner disallowed the taxpayer's deductions of interest with respect to some of the short-term loans on the basis that the loans were incurred to "carry obligations the interest on which is wholly exempt" from income tax within the meaning of section 265(2). The Seventh Circuit upheld the Commissioner's determination finding that a "sufficiently direct relationship" between the continuance of the debt and the carrying of tax-exempt bonds was established by the fact that the tax-exempt securities were used as collateral for the seasonal loans.[10] More importantly for purposes of the instant case, in *Wisconsin Cheeseman, Inc. v. Commissioner, supra* at 422-423, the Seventh Circuit went on to state:

[10] It should be mentioned that the mere fact tax-exempt securities are used to collateralize loans does not, by itself, establish the required direct relationship between the incurrence or continuance of indebtedness and the carrying of such securities. *New Mexico Bancorporation v. Commissioner*, 74 T.C. 1342, 1353 (1980).

In addition, * * * the deduction should not be allowed if a taxpayer could *reasonably have foreseen* at the time of purchasing the tax-exempts that a loan would probably be required to meet future economic needs of an ordinary, recurrent variety. This test would not permit this taxpayer to deduct the short-term loan interest, for its regular business pattern shows that it would have to go into debt each fall if it bought or kept municipals as a long-term investment.[3] This established course of conduct is convincing proof that the underlying reason for these recurring loans was to carry the municipals. [Emphasis added.]

[3]Under this test, the deduction would be disallowed here even if the municipals were not used as collateral for the short-term loans.

We agree with the Seventh Circuit's statement and find that such a circumstance warrants an inference that the indebtedness was incurred or continued for the purpose of purchasing or carrying tax-exempt securities.[11]

In the instant case, it has been DNA's practice since at least the 1940's, and possibly since its business inception in 1938, to attempt to have its cash basis income approximate accrual basis income. In an effort to achieve this objective, DNA annually accelerated its payments to publishers in December. This resulted in December payments being substantially more, and the succeeding January payments being substantially less, than the amounts paid to publishers during the other months. To the extent its cash was insufficient, DNA annually would borrow funds from Bank of America, DPI, and the Drown Trust to fund these large December payments. This pattern of annually borrowing funds dates back to at least 1973.

Despite this pattern of annually borrowing funds at yearend, DNA continued to purchase tax-exempt bonds from excess funds generated from its business. These purchases totaled $395,000, $504,921, and $523,618 for 1976, 1977, and 1978, respectively. It is obvious that, at the time of these purchases, DNA reasonably could have foreseen that a loan probably would be necessary to satisfy its future economic needs, which were of an ordinary, recurrent nature.[12] In fact, petitioners even admitted this on brief.

[11]The foreseeability test has been implicitly accepted by this Court. See *Ball v. Commissioner*, 54 T.C. 1200, 1209 (1970); *Leslie v. Commissioner*, 50 T.C. 11, 20-21 (1968), revd. on other grounds 413 F.2d 636 (2d Cir. 1969).

[12]Petitioners' reliance on *Handy Button Machine Co. v. Commissioner*, 61 T.C. 846 (1974), is misplaced in that, at the time the taxpayer purchased tax-exempt securities, there was no

Petitioners maintain that *Wisconsin Cheeseman, Inc.* is distinguishable from the instant case. They contend that, unlike the taxpayer in *Wisconsin Cheeseman, Inc.*, DNA was not engaged in a seasonal business. We find this distinction irrelevant. It was the fact that the taxpayer had an ordinary, recurrent need for cash, and not the fact that it was engaged in a seasonal business, that was pivotal in *Wisconsin Cheeseman, Inc.* In the instant case, DNA also had a recurrent need for cash that was foreseeable at the time it purchased tax-exempt bonds. In addition, it should be noted that, unlike the situation in *Wisconsin Cheeseman, Inc.*, DNA's cash requirements at yearend for making payments to publishers were not necessitated by business reasons. Rather, substantial amounts of these payments were discretionary and were made only in order to gain the advantages provided by the cash method of accounting (i.e., such payments were made by DNA in an attempt to have its cash basis income approximate accrual basis income).

Petitioners also contend that the length of time for which financing was required in *Wisconsin Cheeseman, Inc.* was much greater than in the instant case. They argue that, because of its strong cash flow, DNA could have repaid its loans to DPI and the Drown Trust within 4 and 17 days of the execution of such loans in 1976 and 1977, respectively. We do not find this argument persuasive. Rather, we find that the fact that DNA could have repaid its loans to DPI and the Drown Trust, but chose not to, supports our finding that the loans were incurred and continued to purchase and carry tax-exempt securities. This is exemplified by the fact that, in April of 1978, DNA purchased $505,000 in tax-exempt bonds when it still owed the Drown Trust $151,500. In fact, an analysis of all of DNA's purchases of tax-exempt bonds from excess cash accumulated from business operations during 1976 and 1978 indicates that all such purchases were made at a time when there were outstanding loans to either DPI or the Drown Trust.[13]

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foreseeable need to borrow funds. Furthermore, the obligation was incurred by the taxpayer to redeem the stock of one of its principal shareholders and thus, was not of an ordinary, recurrent nature.

[13]All purchases of tax-exempt bonds by DNA during 1977, with the exception of a $500 purchase in March of 1977, were made when there were no outstanding loans to DPI or to the

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Finally, petitioners contend that, since they have conceded that the interest DNA incurred with respect to loans obtained from Bank of America is not deductible because such loans were secured by tax-exempt securities, the question of foreseeability with respect to DNA's bank financing is therefore rendered moot. If petitioners' use of the words "bank financing" is intended solely to refer to funds borrowed by DNA from Bank of America, we agree with petitioners' contention. However, we disagree that the question of foreseeability with respect to DNA's obtaining funds from DPI and the Drown Trust is moot. The Seventh Circuit articulated the foreseeability test as an alternative ground upon which to find that a "sufficiently direct relationship" between the continuance of debt and the carrying of tax-exempt bonds could be established. The fact that DNA's loans from DPI and the Drown Trust were unsecured is irrelevant as the Seventh Circuit specifically stated that "Under this [foreseeability] test, the deduction would be disallowed here even if the municipals were not used as collateral for the short-term loans." *Wisconsin Cheeseman, Inc. v. Commissioner*, 388 F.2d 420, 423 n. 3 (7th Cir. 1968).

There is another factor that supports our finding that DNA's indebtedness to DPI and the Drown Trust was incurred and continued to purchase and carry tax-exempt securities. The record demonstrates that DNA kept its portfolio of tax-exempt bonds as a long-term investment. DNA never attempted to liquidate any of its bonds to either alleviate its shortage of funds at yearend or to reduce or eliminate its outstanding indebtedness to DPI and the Drown Trust. We find this to be of particular relevance given the fact DNA's portfolio of tax-exempt bonds was substantial and represented 72.7 percent and 83.1 percent of DNA's total assets as of December 31, 1976, and December 31, 1977, respectively.[14] Such a substantial investment in tax-exempt securities, while not necessarily dispositive, makes it more difficult to find that the relationship between

Drown Trust. However, such purchases were made when it was reasonably foreseeable that DNA would have a substantial cash requirement at yearend.

[14]The instant case clearly is distinguishable from those cases (*Ball v. Commissioner*, 54 T.C. 1200 (1970); *Batten v. United States*, 322 F. Supp. 629 (E.D. Va. 1971)), in which the percentages of the taxpayer's assets invested in tax-exempt securities was quite small.

the loans and the tax-exempt securities was merely a coincidence.[15] To reflect the foregoing,

Decisions will be entered under Rule 155.

JOYCE PURCELL, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 27793-83. Filed February 26, 1986.

Held: On the facts of record, petitioner is entitled to relief under sec. 6013(e), I.R.C. 1954, with respect to certain items of omitted income and is not entitled to such relief with respect to another item of omitted income. Petitioner is not entitled to relief under sec. 6013(e) for disallowed deductions since not contesting respondent's disallowance of the deductions is not sufficient to establish that the deductions were "grossly erroneous" because they had no basis in fact or law.

Alan L. Cates, for the petitioner.
Robert P. Crowther, for the respondent.

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's income tax for the calendar years 1977 and 1978 in the amounts of $82,955.89 and $49,749.21, respectively. The issue for decision is whether petitioner is relieved from liability under section 6013(e)[1] with respect to the income tax resulting from (1) the inclusion in the income of petitioner and her then husband of (a) dividends resulting from amounts paid by a corporation of which they were stockholders for personal travel and entertainment expenses, and (b) a portion of the sales price of petitioner's stock in another corporation allocated to a covenant not to compete; and (2) the disallowance of claimed bad debt and worthless stock deductions with respect to a third corpora-

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[15] *McDonough v. Commissioner*, T.C. Memo. 1977-60. See also *Israelson v. United States*, 367 F. Supp. 1104 (D. Md. 1973), affd. without published opinion 508 F.2d 838 (4th Cir. 1974)(the taxpayer's investment in tax-exempt bonds represented approximately one-third of his assets, a fact that the court stated helped shed light on whether the taxpayer's large bank loan was incurred and continued to purchase and carry tax-exempt securities).

[1] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue.

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tion in which both petitioner and her then husband owned stock.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner, who resided in Franklin, Tennessee, at the time of the filing of her petition in this case, filed a joint Federal income tax return with her then husband, W. Bruce Purcell, for each of the calendar years 1977 and 1978 with the Director, Internal Revenue Service Center, Memphis, Tennessee. For the calendar year 1977, they filed an amended Federal income tax return on Form 1040X.

Petitioner and W. Bruce Purcell were married on July 23, 1952, and were divorced in October 1982. W. Bruce Purcell died, by accidental drowning, in July 1983. During the years 1977 and 1978, both W. Bruce Purcell and petitioner were stockholders and employees of Purcell Enterprises, Inc. This company was run primarily by Mr. Purcell, and petitioner's duties were limited to signing checks on the corporation's bank account when Mr. Purcell was out of town and some typing and clerical work when her services were needed in the office. She did not deal with the corporate customers. The company had an American Express account and each of the officers of the company, including Mr. Purcell, had an American Express Card in his name on this account. Petitioner had a company American Express Card in her name, permitting her to make charges to the account of Purcell Enterprises, Inc.

Petitioner occasionally accompanied her husband on trips and at his request charged the cost of the hotel room that she and her husband used and other costs of the trip on the corporate American Express Card issued in her name. Other than the charges made on the card at her husband's request, petitioner made only a few charges on the company American Express Card. Occasionally she made other charges on this card and did not keep a record or diary of the charges she made. Petitioner discussed the use of this card with Mr. Purcell and was told by him that he would take care of the charges she made for personal purposes, because the corporation always owed him money. Petitioner

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charged a few meals in Nashville to this credit card and charged lodging in Knoxville, where her children were in school, to this credit card. Petitioner also charged a small purchase of foreign currency to this credit card.

In February 1974, a corporation, International Demolition & Salvage Co., Inc. (International Demolition), was formed under the laws of the State of Tennessee. During the years 1977 and 1978, petitioner and W. Bruce Purcell each owned 25 percent of the outstanding stock of International Demolition. Petitioner was the treasurer of International Demolition during 1977 and 1978 and was a corporate director in these years. International Demolition had a sustained history of losses throughout its existence. It was in financial difficulties in 1977 and 1978 and ultimately failed. Petitioner's then husband, W. Bruce Purcell, and other shareholders of International Demolition infused money into the corporation in 1976, 1977, and 1978, which moneys were treated on the corporate books as loans to the corporation.

Reese Tires, Inc., was a corporation the stock of which was owned by petitioner and Mr. Ira Reese. As of April 15, 1977, petitioner owned 560 shares of the stock of Reese Tires, Inc., and Mr. Reese owned 480 shares of the stock of that corporation. Under date of April 15, 1977, petitioner, W. Bruce Purcell, and Ira Reese entered into an agreement to sell petitioner's and Mr. Reese's stock in Reese Tires, Inc., to Universal Tire, Inc., a Tennessee corporation. The sales agreement was negotiated by Mr. Purcell and Mr. Reese. Petitioner did not participate in the negotiation for the sale of the stock of Reese Tires, Inc., to Universal Tire, Inc. However, she did sign the agreement and initialed the agreement in several places where changes were made. One of the changes initialed by petitioner was in a clause agreeing that neither petitioner, Mr. Purcell, nor Mr. Reese would compete with Universal Tire, Inc., in the tire business for a period of 3 years in specified locations. One of the changes made in the agreement by pen, which was initialed by petitioner, was changing 5 years to 3 years in this clause of the agreement.

The income tax returns of petitioner and her then husband for the years 1977 and 1978 were prepared by a certified public accountant. Except for certain items of

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medical expenses and charitable contributions and other types of personal items, none of the information used in the preparation of the returns was furnished to the CPA by petitioner. Most of the information used by the CPA in preparing the joint returns of petitioner and her then husband for the years 1977 and 1978 was obtained by the CPA from a Mr. John H. Moses who was the comptroller of both Purcell Enterprises, Inc., and International Demolition. If the CPA needed additional information or to clarify information he had, generally he would ask a question of the comptroller and if the comptroller could not answer the question, he would attempt to get the information from Mr. Purcell. The CPA very seldom consulted with Mr. Purcell and did not consult at all with petitioner. When the CPA prepared the returns, he was of the opinion that he had sufficient information to prepare the returns correctly. The CPA made no audit of the records of petitioner or Mr. Purcell in preparing their individual income tax returns, but prepared the returns from information furnished to him. Petitioner did not review the returns prepared by the CPA.

Petitioner personally guaranteed certain notes of her then husband, W. Bruce Purcell, to banks in Nashville, Tennessee, for loans made to him.

Petitioner's primary occupation was a housewife. She married Mr. Purcell shortly after she graduated from high school. She worked after they were married to assist Mr. Purcell with his college education. When petitioner signed the guarantees of her husband's loans, he told her that his businesses had sufficient assets to pay off these business debts.

There were problems in connection with petitioner's marriage during 1977 and 1978. Mr. Purcell was away from home during much of the time in these years and was drinking heavily. He also was seeing the woman whom he married after he and petitioner were divorced in 1982.

In the divorce decree, a recitation is made that petitioner and Mr. Purcell had lived apart since 1979. In the divorce decree there was incorporated a property settlement agreement between petitioner and Mr. Purcell. In the property settlement agreement, petitioner received the family home, which was free and clear at the time, and the furnishings of

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that home. She also received an automobile. The agreement provided for certain cash payments by Mr. Purcell to petitioner over a period of 121 months. Paragraph 7 of the agreement provided as follows:

> 7. That HUSBAND shall keep in full force and effect and pay all necessary premiums for three (3) certain policies of insurance with the New York Life Insurance Company, being Policy Numbers 33-002-776, 36-402-141, and 36-426-995, in the total face amount of Nine Hundred Thousand ($900,000.00) Dollars, which policies of insurance are owned by and payable to WIFE as beneficiary to secure this agreement, and further HUSBAND shall keep in full force and effect and pay any and all necessary premiums for a major medical hospitalization insurance program in at least the amount of Fifty Thousand ($50,000.00) Dollars and both collision and liability insurance for WIFE in the operation of any vehicle or conveyance of any nature whatsoever in at least the amount of Three Hundred Thousand ($300,000.00) Dollars until the death or remarriage of WIFE or for said One Hundred Twenty-One months from July 1, 1982 to July 1, 1992.

The property settlement agreement also transferred to petitioner 15 cemetery lots in Woodlawn Memorial Park in Nashville, Tennessee, and Mr. Purcell's interest in 6 parcels of real estate specifically described in the agreement, some of which were owned jointly by Mr. Purcell and others. The agreement provided that Mr. Purcell would execute a note in the amount of $121,000 to petitioner to secure the payment of the principal sum of $121,000 as periodic alimony in monthly installments of $1,000 each for 121 months, beginning on July 1, 1982, and continuing through July 1, 1992, unless petitioner dies or remarries prior to the date of the last payment. The property settlement agreement also provided for the transfer by Mr. Purcell of certain certificates of stock in the bank of Maryville, Tennessee, to petitioner. The only property granted to Mr. Purcell by the agreement, other than his personal effects which he was to remove from the family residence, was all right, title, and interest which petitioner had in any business interests of Mr. Purcell, including but not limited to Purcell Enterprises, Inc. Mr. Purcell assumed the responsibility and liability for all outstanding debts and bills with respect to his business operations, particularly including indebtedness to the Third National Bank of Nashville, Tennessee, and the Continental National American Insurance & Bonding Co.

with regard to the bonding of construction contracts in Mr. Purcell's business. Mr. Purcell agreed to hold petitioner harmless with respect to all indebtednesses which he had incurred or which were incurred in connection with his businesses.

Respondent in his notice of deficiency increased the reported income of Mr. Purcell and petitioner by $17,750 in 1977 and $5,298.69 in 1978 as nonbusiness bad debts from Reese Tires, Inc., which were not allowable since it had not been established that they became worthless in 1977 or 1978. For the years 1977 and 1978, respectively, respondent increased petitioner's reported income by $144,411.26 and $95,185.05 because of disallowance of claimed deductions of bad debts of International Demolition on the ground that the debts did not become worthless in 1977 or 1978 or otherwise represent an allowable deduction, and also increased the reported income by $26,904.85 in 1977 by disallowance of a claimed long-term capital loss from worthless stock of International Demolition on the ground that it had not been established that the stock became worthless in that year. Respondent increased the reported income of Mr. Purcell and petitioner by $28,258.10 in 1977 and $25,575.65 in 1978 with the explanation that the items represented dividends under sections 301 and 316 of the Internal Revenue Code because of benefits received from the permitted use of corporate property without compensation. The explanation of these items showed that in 1977, $7,675.08 was from personal use of aircraft and $20,583.02 from payment of personal travel and entertainment expenses and that in 1978, $8,681.03 was from personal use of aircraft and $16,894.62 from payments by Purcell Enterprises, Inc., of personal travel and entertainment expenses.

Respondent in 1977 increased Mr. Purcell's and petitioner's reported income by $15,300, explaining that this was the amount of the purchase price of the stock of Reese Tires, Inc., paid by Universal Tire, Inc., for the purchase of a covenant not to compete and therefore should have been shown as ordinary income on the tax return. Respondent made a compensating adjustment in petitioner's 51 percent share of the payment from Universal Tire, Inc., which had been reported as gain from the sale of the stock. In

addition, respondent made certain other minor adjustments with respect to interest deductions and a change in the amount of a bad debt loss which have not been placed in issue in this case.

Petitioner, at the trial, conceded that the adjustments made by respondent in the deficiency notice were correct for the purpose of this case, stipulating that—

petitioner intends to limit her challenge to the adjustments made by the Commissioner in his notice of deficiency to whether I.R.C. sec. 6013(e), as amended by sec. 424 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 801-803, affords her relief as an innocent spouse.

At the trial, petitioner's counsel stated that petitioner was unable to question the adjustments made by respondent because of lack of knowledge of the transactions.

OPINION

Section 6013(e), as amended by the Tax Reform Act of 1984, Pub. L. 98-369, sec. 424(a), 98 Stat. 801-802 (1984-3 C.B. 309-310),[2] provides that a spouse is relieved of liability

[2] Sec. 6013(e), as amended by the Tax Reform Act of 1984, provides as follows:

SEC. 6013(e). SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary, if(I/m

(A) a joint return has been made under this section for a taxable year,

(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

(2) GROSSLY ERRONEOUS ITEMS.—For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse—

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

(3) SUBSTANTIAL UNDERSTATEMENT.—For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

(4) UNDERSTATEMENT MUST EXCEED SPECIFIED PERCENTAGE OF SPOUSE'S INCOME.—

(A) ADJUSTED GROSS INCOME OF $20,000 OR LESS.—If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.

(B) ADJUSTED GROSS INCOME OF MORE THAN $20,000.—If the spouse's adjusted gross

under regulations prescribed by the Commissioner where a joint return has been made for a taxable year and on that return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse, if the other spouse establishes that in signing the return she did not know, and had no reason to know, that there was such substantial understatement, and taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for the taxable year attributable to such substantial understatement.

Grossly erroneous items are defined to mean "any item of gross income attributable to such spouse which is omitted from gross income" and "any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law." Sec. 6013(e)(2)(A) and (B). Substantial understatement "means any understatement * * * which exceeds $500." Sec. 6013(e)(3).

There is a further provision requiring that the understatement must exceed a specified percentage of the income for the pre-adjustment year of the spouse claiming the benefit of the statute. However, the parties in this case have stipulated facts which clearly show that petitioner's income for the pre-adjustment year was such that this requirement is met.

Respondent apparently admits that petitioner has met the requirements of section 6013(e), as amended, with respect to omission of income resulting from the determination of a dividend to petitioner's former husband because of personal use of an aircraft, although he argues generally that petitioner has failed to show that it would be inequitable to hold her liable for the total deficiency in this case.[3] Also,

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income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting "25 percent" for "10 percent."

(C) PREADJUSTMENT YEAR.—For purposes of this paragraph, the term "preadjustment year" means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.

[3] Respondent in his brief states as follows:

"The fourth area of adjustment involves income realized by petitioner's husband from his personal use of an airplane maintained by Purcell Enterprises, Inc. The respondent concedes that the petitioner is an innocent spouse with respect to said income.

"At the start of the trial the court asked whether it was respondent's view that a determination of innocent spouse status with respect to omitted income items could be made separately from a determination of innocent spouse status with respect to disallowed deduction items. It is respondent's position that the two areas of adjustment, i.e., omitted

respondent does not claim that the items on which petitioner claims relief as grossly erroneous items were not items of Mr. Purcell. Respondent contends that petitioner either knew, or had reason to know, that Purcell Enterprises, Inc., was paying personal expenses of petitioner and her then husband. Respondent contends that petitioner did in fact know that there had been a covenant not to compete signed with respect to the sale of the stock of Reese Tires, Inc., and that all petitioner has shown with respect to the income allocable to the covenant not to compete is that she did not know the tax effect of such a covenant being part of a contract for the sale of stock.

Petitioner takes the position that she did not know, and had no reason to know, of the omission from income of any of the items determined by respondent to have been omitted. Petitioner further takes the position that she did not know, and had no reason to know, of the claimed deductions for bad debts and worthless stock in connection with International Demolition and that the requirement of the item being grossly erroneous is met in that the claimed deductions are in an amount for which there is no basis in fact or law. Her position is that her failure to contest the determination of respondent that the claimed bad debt losses and worthless stock deduction are not allowable is sufficient to show that the deduction items are grossly erroneous.

Respondent argues that petitioner knew or certainly had reason to know of the claimed bad debt loss and worthless stock deductions, that these deductions are not grossly erroneous items as defined in section 6013(e)(2)(B) since they did have some basis in fact and law, and in any event petitioner has not established to the contrary. Respondent also argues that it would not be inequitable to hold petitioner liable for the deficiency resulting from the disal-

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income and disallowed deductions, may be considered separately in determining whether petitioner is an innocent spouse."

Because of these two concessions by respondent, it is clear that respondent agrees with petitioner that under sec. 6013(e), as amended, individual items of income or deductions may be separately considered in determining whether there is a substantial understatement of tax attributable to grossly erroneous items of one spouse. Since petitioner approached her case on an item-by-item basis, we do not consider there to be an issue in this case as to whether different items of income and deduction may be separately considered in determining whether a taxpayer is entitled to any relief as an "innocent spouse."

lowance of these claimed deductions under the facts and circumstances of this case.

In our view, petitioner did not know or have reason to know that personal expenses and personal travel were being paid for by Purcell Enterprises, Inc., and therefore did not know, or have reason to know, of the omission of these items from the joint tax returns she filed with her then husband. The record shows that petitioner had an American Express Card of Purcell Enterprises, Inc., which she used to pay travel expenses for herself and her husband when her husband was on a business trip. The record also shows that she used this card for certain personal items. However, the testimony shows that her husband represented to her that amounts charged on the American Express Card of Purcell Enterprises, Inc., had to be justified as company expenses in order to be paid by the company and that any personal expenses which petitioner put on the card were being paid by him personally and not by the company. In fact, the company comptroller testified that charges on the company's American Express Card were required to be justified in order for him to authorize payment by the company, and in connection with charges involving the Purcells, he looked to Mr. Purcell for justification. Under the circumstances, we conclude that petitioner did not in fact know that the personal charges she put on the Purcell Enterprises, Inc., American Express Card were being paid for by the company rather than by her then husband and did not know that he was charging personal items to the company credit card.

In our view, petitioner must have known in connection with the sale of the Reese Tires, Inc., stock that the contract of sale contained a covenant not to compete. Although she did not assist in negotiating the sale, she was the owner of the stock and a signatory to the contract. One of the persons to whom the noncompete provision applied was petitioner and another was her then husband, Mr. Purcell. Not only did petitioner sign the contract, she initialed a change in the years for which the covenant not to compete was effective. Petitioner never specifically testified that she did not read the agreement with respect to the sale of stock that she signed, although she testified that her

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husband did all the negotiating. In our view, the evidence here does not support lack of knowledge on the part of petitioner with respect to the terms of the contract for the sale of the stock of Reese Tires, Inc. Certainly petitioner did not know the legal effect of the provision with respect to a covenant not to compete. However, the cases are clear that the spouse claiming to be relieved from liability for omission from income of an item must be unaware of the circumstances which give rise to that omission and not merely to the tax consequences of the facts. *McCoy v. Commissioner*, 57 T.C. 732 (1972); *Quinn v. Commissioner*, 62 T.C. 223 (1974), affd. 524 F.2d 617 (7th Cir. 1975); *Smith v. Commissioner*, 70 T.C. 651, 672-673 (1978). As we pointed out in the *Smith* case, it is immaterial that both spouses were unaware of the tax liability created by the transactions of which they were aware. Here, we do not know whether Mr. Purcell was aware of the tax liability created by a part of the amount paid under the contract for sale of the Reese Tires, Inc., stock being allocable to a covenant not to compete, but it is clear that petitioner did not know the tax consequences of having this provision in the contract. However, this is immaterial since we conclude that the evidence shows that she did know that the noncompete agreement was in the contract.

The record is clear that petitioner did know of loans made by her then husband to International Demolition. From the evidence we conclude that she did not examine the returns sufficiently to know that these amounts had been deducted in 1977 and 1978 as worthless debts on the joint returns she filed with her then husband. We also conclude that she did not examine the returns sufficiently to know that there had been a deduction for worthless stock of International Demolition taken as a deduction on the returns. However, petitioner has made no showing as to the circumstances which caused these items to be deducted. The accountant testified that he thought when he prepared the joint returns of petitioner and her then husband that all items in the returns were accurate. Certainly under these circumstances he must have done some investigation of the financial condition of International Demolition. The record shows that this company was in bad financial condition. In our

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view, petitioner's conceding that respondent's adjustments with respect to the worthless stock and bad debt deductions are correct is not sufficient to establish that the claimed deductions were in an amount for which there was no basis in fact or law. If the statute had intended that a mere concession that respondent was not in error in disallowing a claimed deduction was sufficient to cause the item to be grossly erroneous as having no basis in fact or law, it would have so provided.

Prior to the amendment of section 6013(e) by Pub. L. 98-369 in 1984, no relief was granted where the deficiency was because of the disallowance of claimed deductions. *Resnick v. Commissioner*, 63 T.C. 524 (1975); *Allen v. Commissioner*, 61 T.C. 125, 132 (1973), affd. on this issue and revd. on another issue 514 F.2d 908, 915 (5th Cir. 1975). In explaining the reason for the change in the law with respect to disallowed deductions made by Pub. L. 98-369, in 1984, the House committee report states that—

> The Committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, for example, where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered. [Supplemental Report of Comm. on Ways and Means, H. Rept. 98-432 (Pt. 2), on H.R. 4170 (Tax Reform Act of 1984), at 1502 (1984).]

This report further states with respect to the changes in the bill as follows:

> Under the bill, the innocent spouse (sec. 6013(e)) rule will apply to cases in which the tax liability results from a substantial understatement of tax that is attributable to grossly erroneous items (including claims for deductions or credits, as well as omitted income) of the other spouse. Grossly erroneous items include any item of income that is omitted from gross income, regardless of the basis for omission. A claim for deduction or credit will be treated as a grossly erroneous item only if the claim had no basis in law or fact. The bill defines a substantial understatement as any understatement of tax that exceeds $500. As under present law, relief may be granted only where it would be inequitable to hold the innocent spouse liable.

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It is clear from the statute itself, and made even clearer by the committee reports, that whereas any omission of income resulting in an understatement of tax in excess of $500 is to be considered a grossly erroneous item, only deductions without a basis in fact or law are to be considered grossly erroneous. Therefore, in order to be relieved from tax resulting from a disallowed deduction, it is incumbent on a taxpayer to prove that the claimed deduction not only is not properly allowable but that it has no basis in fact or law. To establish that the deduction is a grossly erroneous item under this definition is part of the burden of a taxpayer claiming to be an innocent spouse.

Here, petitioner has made no showing that the bad debt deductions which were disallowed by respondent and the worthless stock deduction that was disallowed had no basis in fact or law. All that has been shown is that she did not contest the adjustments as made by respondent. In fact, the evidence that is in the record with respect to these items indicates that they were not "grossly erroneous" from the standpoint of being "phony" deductions. The record shows that loans had been made by petitioner's husband to International Demolition and that that company was in bad financial condition in 1977 and 1978. The accountant who prepared the joint returns of petitioner and her then husband testified that he thought he had sufficient information to justify the items shown on the returns, and the comptroller of Purcell Enterprises, Inc., who also handled the books of International Demolition, testified that he had furnished information to the accountant.

Under the facts of this case, there has been no showing that the claimed deductions had no basis in fact or law. They were not "phony" deductions as referred to in the committee report. We therefore conclude that petitioner is not an innocent spouse with respect to the claimed bad debts and worthless stock deductions.

Since respondent has conceded that petitioner is an "innocent spouse" with respect to the constructive dividends received by her husband from the private use of the airplane owned by Purcell Enterprises, Inc., and we have concluded that petitioner did not know, or have reason to know, of the constructive dividends from the payments by

that corporation of personal bills and travel, it is necessary for us to determine whether it would be inequitable to hold petitioner liable for the deficiency in tax attributable to these understatements of income.

Whereas the law prior to the 1984 amendment specifically referred to whether the spouse claiming relief from tax significantly benefited from the omissions from income, the present law does not specifically contain this provision. However, even though the present statute does not specifically refer to the other spouse receiving substantial benefits from the omissions or wrongfully claimed deductions, in our view it would not be inequitable to hold the other spouse liable for the deficiency if such substantial benefits were received. Therefore, we deem it necessary to determine whether petitioner received substantial benefits from the omission of the constructive dividends from the income reported on the returns.

The record shows no benefit to petitioner from her husband's use of the company plane and only very minor benefits received by petitioner from the payment by Purcell Enterprises, Inc., for a few meals and some lodging she charged to the American Express Card issued in her name. Certainly these benefits were not substantial. The record also shows that under the agreement incident to her divorce from Mr. Purcell, petitioner received most of the property accumulated during the marriage of the parties and, in addition, Mr. Purcell was required to keep insurance policies payable to her in force to ensure periodic payments. Petitioner testified at the trial that the property which she received in the divorce settlement had been acquired by her and Mr. Purcell long before the years here in issue and that prior to the years here in issue, she was actually the owner of the insurance policies which Mr. Purcell was required to keep in effect, and had paid the premiums on these policies. She testified that she did not receive the periodic payments required under the agreement. Although not precisely shown in the record, petitioner apparently did receive the proceeds of the insurance policies upon Mr. Purcell's death. She testified about the requirement she was facing of paying Mr. Purcell's debts which she had guaranteed.

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Petitioner claims that she did not substantially benefit from the various items of omitted income.

Since we have held that petitioner is not entitled to relief under section 6013(e) for the omitted income from the covenant not to compete or from the disallowance of the deductions for bad debts and worthless stock, we need only consider whether it would be inequitable to hold petitioner liable for the tax on the omitted income from constructive dividends. The regulation in effect with respect to the prior law provided, in section 1.6013-5(b), Income Tax Regs., that whether it is inequitable to hold a person liable for the deficiency in tax is to be determined on the basis of all the facts and circumstances.[4] This section of the regulations states that in making the determination, a factor to be considered is whether the person seeking relief significantly benefited, directly or indirectly, "from the items omitted from gross income." This regulation goes on to say that normal support is not to be considered a significant benefit. It further refers to a person seeking relief receiving from his spouse "an inheritance of property or life insurance proceeds which are traceable to items omitted from gross income by his spouse."

Here, the record shows that the property received by petitioner in the divorce proceeding had been acquired in years prior to the years here in issue. Petitioner had paid the insurance premiums prior to her divorce from Mr. Purcell. The omitted income was from personal items paid by Purcell Enterprises, Inc. Clearly, the use of the airplane by Mr. Purcell for personal purposes in no way benefited petitioner, and the Government apparently does not contend

[4] Sec. 1.6013-5(b), Income Tax Regs., provides as follows:

(b) *Inequitable defined.* Whether it is inequitable to hold a person liable for the deficiency in tax, within the meaning of paragraph (a)(4) of this section, is to be determined on the basis of all the facts and circumstances. In making such a determination a factor to be considered is whether the person seeking relief significantly benefitted, directly or indirectly, from the items omitted from gross income. However, normal support is not a significant "benefit" for purposes of this determination. Evidence of direct or indirect benefit may consist of transfers of property including transfers which may be received several years after the year in which the omitted item of income should have been included in gross income. Thus, for example, if a person seeking relief receives from his spouse an inheritance of property or life insurance proceeds which are traceable to items omitted from gross income by his spouse, that person will be considered to have benefitted from those items. Other factors which may also be taken into account, if the situation warrants, include the fact that the person seeking relief has been deserted by his spouse or the fact that he has been divorced or separated from such spouse.

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to the contrary. Although petitioner may have received some small benefit from the payment of travel and entertainment expenses by the corporation, from her testimony it is reasonably clear that whatever benefit she received was not significant. She only occasionally went on trips with Mr. Purcell and made insignificant charges on her American Express Card which she thought Mr. Purcell was personally paying.

Based on the record as a whole, we conclude that petitioner did not significantly benefit from the constructive dividends received by Mr. Purcell from Purcell Enterprises, Inc., because of the payment by that corporation of personal expenses for meals, travel and entertainment for Mr. Purcell and, to some extent, for petitioner. We therefore conclude that with respect to the entire constructive dividends from Purcell Enterprises, Inc., in each of the years here in issue, petitioner is entitled to relief under section 6013(e).

Decision will be entered under Rule 155.

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